

THE SCIENCE OF FINANCE

AN INVESTIGATION OF

PUBLIC EXPENDITURES AND
PUBLIC REVENUES

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PREFACE.

THE need of a text-book upon the Science of Finance for the use of colleges and universities is, I believe, generally recognised, and it has been my first purpose in preparing the present treatise to write a book that shall supply this need. A second purpose for which the work was undertaken, and one which perhaps exerted greater influence upon the choice of topics and the manner of their discussion, was the desire to contribute something to the development of a financial system that shall satisfy the peculiar requirements of Federal and local government in the United States. The initial step in this direction consists undoubtedly in a clear presentation of fundamental principles and in a true classification of the means to be employed; but this treatise does not content itself with analysis and theory. In all important cases it applies the administrative test to theoretical conclusions, and insists that every constructive proposal should be judged by its adaptation to existing conditions. It seems proper to make mention of this fact because those suggestions which give character to the programme of financial reform here submitted cannot be appreciated except the reader recognise the emphasis placed upon administrative considerations.

Should it prove that this book is too extended for use in institutions of limited elections, it is suggested that Book I, Part I, and Chapters I and II of Book I, Part II, may be omitted without seriously impairing the logical presentation of the subject.

I cannot permit this opportunity to pass without expressing my obligation to Professor F. M. Taylor of the University of Michigan for his many pertinent suggestions and criticisms. I desire also to acknowledge my gratitude to Professor Frank H. Dixon of Dartmouth College, who did me the favour of reading the final proof. It was necessary to consent to publication during my absence from the country, a statement which makes evident the extent of my indebtedness to Dr. Dixon.

H. C. A.

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THE SCIENCE OF FINANCE.

INTRODUCTORY CHAPTER.

GENERAL CONSIDERATIONS RESPECTING THE SCIENCE OF FINANCE.

DEFINITION OF THE SCIENCE OF FINANCE.

THE THREE FISCAL AXIOMS

- (1) The Patrimony of the State must not be Impaired.
- (2) Political Restraints must be Established.
- (3) The Political Organization must be Recognised.

THE NATURE OF PUBLIC WANTS.

- (1) They Are Reducible to a Demand for Money.
- (2) Consideration of Gratuitous Service.
- (3) Consideration of Coerced Service.

GENERAL DIVISIONS OF THE SCIENCE OF FINANCE.

1. **Definition of the Science of Finance.**—The Science of Finance treats of public expenditures and public income and includes in its investigations all those varied relations necessarily implied when considering such expenditures and income. In its restricted sense, it pertains to the technic of treasury administration and deals with those practical questions that arise in connection with the management of the public purse. Regarded from the pedagogical point of view, it forms a part of that comprehensive study, the Science of Economics, and through economics it is related to the entire group of political and social sciences. Speaking definitely, and with a view of grouping the problems which it includes, the Science of Finance undertakes an analysis of the wants of the State and of the means by which those wants may be supplied. All problems which find proper place within the domain of this study may be considered in connection with one of the two following questions:

First. What are the legitimate and necessary wants of a State ?

Second. How may these wants be the most economically and advantageously supplied ?

A number of problems in public economy commonly regarded as forming a part of the Science of Finance must be excluded if the view just expressed respecting the nature of that science be accepted as correct. Such, for example, are the problems of money, currency, and banking. These have to do with the mechanism by which all financial operations are carried on, and not with the operations themselves. A sound monetary system, a safe currency, and an efficient banking organization are important for private as well as public transactions. They form a part of the conditions necessary for the transfer of values, whether such transfers be between two or more citizens or between the subjects and the State. They pertain primarily to the machinery of commerce and are properly treated as chapters in Political Economy, a study which may be adequately defined as the science of industrial association.

It is necessary that the distinction here brought to light should be firmly grasped in order to guard at the outset against misapprehension respecting the scope and purpose of the Science of Finance. It is true that under certain conditions questions of money, currency, and banking may play an important part in the financial policy of the Government. Suppose, for example, some great fiscal exigency to arise, like the advent of a war, and that the Government lack the instruments and agencies with which to make headway against fiscal wants. It is quite possible that an administration may feel obliged, as a preliminary step for collecting adequate revenue, to undertake the creation of a new system of currency or banking. Such was the case in the United States in 1861. It is also conceivable, though the admission is full of danger, that a government may, on account of failure of all other means of filling a depleted treasury, be forced to issue legal-tender notes which shall serve as money in commercial transactions. Under such circumstances a law which aims to create a banking system, or to provide a new medium of circulation, becomes, for the time being, a part of the financial policy of the administration. From this, however, it does not

follow that a discussion of banking principles or of the principles of monetary science forms a legitimate part of the Science of Finance. The conclusions arrived at from such a discussion find their support in Political Economy, and must be accepted by the financier as part of the equipment with which he approaches the solution of any particular financial question.

Another mistaken idea respecting the Science of Finance arises from failure to distinguish between public and private financiering. The former holds in mind the service to be rendered, the latter the profit to be derived from the service. This distinction, the recognition of which is essential to the proper understanding of the Science of Finance, will be more fully explained in connection with the discussion of certain fiscal axioms which follows. The Science of Finance has to do with public and not with private financiering.

2. The Three Fiscal Axioms—Since the Science of Finance treats of the wants of the State and the means of their supply, it seems proper at the outset to inquire respecting the nature of a State. The scope of such an inquiry must be limited by its purpose, and its purpose is to discover if the State possess any universal or permanent characteristics which may be accepted as final in the formulation of financial principles, or in passing judgment upon specific financial questions. This inquiry need not be undertaken by the student of finance as an original investigation, for the teachings of political philosophy furnish all the necessary information for the unfolding of his peculiar science.

Current teachings respecting the nature and function of the State point to three fundamental and universally true principles, which we venture to term fiscal axioms, each of which rests upon a fundamental and universally recognised characteristic of the State.

(1) *The Patrimony of the State must not be Impaired.*—This axiom rests upon the fact that the life of the State is conceived to be eternal. As a matter of history, states do come to an end,—they are born, they grow, they decay, they die,—but no statesman would for a moment think it possible to present a policy adjusted to this fact, nor would the publicist in discussing a current question accept the decay of the State as a controlling consideration. Even

historians when they describe the rise and fall of empires do so for the purpose of pointing out the cause of decay, in order that living states may avoid the errors of the past. This is the first of the many instances which will present themselves as our study proceeds, in which the public and the private point of view are brought strongly into contrast. An individual is obliged to recognise the fact of death and to adjust his affairs accordingly. To take an extreme case for illustration, (and one of more frequent occurrence in Europe than in this country), a man who has no one depending upon him may convert his property into a life-annuity; that is to say, he may purchase with the total of his property a promise from the State, or from some responsible corporation, of an annual payment during life. He has no interest in the disposal of his property after death, and exchanges it for an assured living while he may live. This as a business transaction is controlled by the thought that the period in which one's patrimony may be enjoyed is limited, and, judged from the private point of view, is not necessarily bad financiering. Such considerations, however, cannot be entertained by the public financier. He is called upon to manage the property of the people whose interests endure in perpetuity. He must reason from the point of view of the State whose existence knows no limit; he is not, therefore, at liberty to commute the patrimony of the State into extraordinary income for a few years, nor in any manner to dissipate public property. It is a fundamental principle of constitutional law that each legislature shall hand down to its successor all the rights and powers and jurisdictions which it received from its predecessor, so in matters of public finance it is incumbent that each succeeding administration shall find as broad a field from which to supply its needs and as fruitful a source of supply as the administration which preceded it. This statement is so reasonable and springs so naturally from the conception that the State is a personality of perpetual life, that its mere statement must secure for it universal recognition. It provides the Science of Finance with the first of its fundamental or axiomatic truths, namely: *A sound financial policy will not impair the patrimony of the State.*

But what, it may be asked, is the patrimony of the State? This depends upon the stage of development at which a peo-

ple have arrived and upon the relation which at any time exists between political and industrial life. In feudal times the patrimony of a State consisted primarily in the royal demesne, and the fiscal axiom under consideration led to the formulation of many rules respecting the industries of agriculture, forestry, fisheries, and the like, designed to maintain the extractive industries in a flourishing condition. These rules properly collated and classified, whatever the name by which they may be known, formed the substance of the Science of Finance for the time to which they pertain. In Germany they took the name of *Kameralwissenschaft* and were in fact the historical forerunner of the later science.

In modern times, and among peoples who practise the law of private property and the theory of individual rights, the patrimony of the State consists in a flourishing condition of private industries. Public revenue is not secured to any great extent from the ownership and direct management of productive property, but from taxes levied upon industries the property of citizens. The more flourishing these industries, the larger is the fund to which the State may appeal for public revenue, and on this account it should be the prime consideration of the financier that nothing be done which will in any way tend to impair the efficiency of private industry. A sound policy of public finance must rest upon a thorough knowledge of political economy.

To illustrate yet farther what is meant by the patrimony of the State, it may be remarked that there appears to be at the present time a tendency toward the substitution of public for private ownership in certain industries. In so far as this tendency is realized by modern governments it appears that the patrimony of the State consists in the productiveness of the industries in question. Suppose, for example, the railway, express, and telegraph industries to have been assumed by the Federal Government; or the service of supplying gas, electricity, water, and rapid transit to have been assumed by the municipalities. The source of revenue in these cases would be the profit secured by the operation of such industries, and these industries would then become a part of the patrimony of the State. It seems, then, that this word *patrimony*, which the first fiscal axiom asserts will not be im-

paired by the financial policy, is not a thing that is fixed, but that it changes with the ideas of political and industrial rights entertained by the people. The axiom, however, remains always the same, and by it the financier is precluded from entering upon any line of policy which shall permanently impair the sources of public revenue *x*.

(2) *Political Restraints must be Established.*—A second permanent characteristic of the State is that the State does not exist in and of itself, but for the purpose of performing certain delegated functions. It has a legal rather than a physical or a psychological existence. The important conclusion which follows from this statement is that public administration is not confined to the ordinary motives which give direction to business transactions. The State stands by itself, and, there being no possibility of comparison, it cares nothing for riches as such. The desire for profit which controls all private transactions is foreign to its nature, and, consequently, in all that the State does it is superior to the rules of ordinary capitalistic industry. The principle of competition which guarantees a just price for most commodities has no play in public affairs. All State enterprises are, or at least they may be, strict monopolies, and there is on this account no guarantee in the nature of the conditions under which the services are rendered that the subjects of a State will be treated in a spirit of fairness. That which the individual desires in the expenditure of his income (and this desire is regarded as a fundamental right among commercial peoples) is, that he shall pay no more for a service than its legitimate and necessary cost, no matter whether it be rendered by the Government or by a private person. Any charge in excess of cost is conceived to be extortionate. Now, the peculiar fact to which the above-mentioned characteristic of the State points is, that there can be no commercial guarantee of fair treatment in the relations which exist between the State and the citizen. It is essential, therefore, that other means be devised for the control of those who are intrusted with the exercise of public powers. The two principles known to civilized society by which the actions of men are controlled, so far as these actions pertain to the rendering of services, are the *competitive* principle and the *political* principle. Besides these two, there are no other means of controlling the actions

of men; and if conditions are such that the competitive principle cannot produce the desired results, reliance must be placed upon the political principle. The fundamental or axiomatic truth to which these considerations lead lies wholly upon the surface, and may be accepted as the second of the fiscal axioms which find their root in the permanent characteristics of the State. It is as follows: *A sound fiscal system will establish political restraints in order to insure that all services rendered by the State shall be rendered at the least possible cost.*

The importance of this truth in directing the development of the Science of Finance will be more clearly recognised when it is observed that the State is the sole residence of coercive power.* It alone of all organizations or associations of men has the moral and legal right to use force in the attainment of its ends. It is of course essential for the welfare of society that the right of coercion should be lodged somewhere, and that certain persons should be intrusted with its exercise; but there is great danger incident to the mere existence and recognition of this right. The tyrannies which historians describe have commonly arisen from the fact that the grant of coercive power, which from its very nature inheres in government, is used by governors for personal ends. The form of this tyranny changes with the successive fashions of society, but its character is always the same, namely, the employment of a public power in a personal manner. Now the Science of Finance assumes no priority as guardian of the liberties of the people; but so far as these liberties are endangered by the constant encroachment of personal interest into public service, there is no domain of administration in which provision may be made against such encroachments as easily or as effectively as in that which has to do with the collection and the expenditure of public moneys. This entire subject will be more fully considered in connection with Budgetary Legislation. Sufficient has been said here to show that, because the State is naturally monopolistic and exclusive in all that it undertakes, and because it is the sole residence of coercive power, the principle of public financing, which asserts that public service must be rendered at cost, and the axiom that political restraints must be established in

* Bastable, *Public Finance*, p. 41.

order to realize this principle, are truths which lie at the basis of the Science of Finance.

(3) *The Political Organization must be Recognised.*—A third characteristic of the State is that the State is an historical product, and as such takes upon itself various and peculiar forms. Government is a permanent fact in human society, but the working theory which underlies government is subject to constant change. It is not the same for different peoples at the same time nor for the same peoples at different times; yet at any stated period it reflects the social aspirations of the people, and conforms to the conception of individual rights and duties entertained, as also to the stage of development and condition of intelligence at which the people have arrived. It is the recognition of this fact which leads one to appreciate the third of the fiscal axioms disclosed by an analysis of the characteristics of the State, which is as follows: *A successful financial system will conform to the political ideas which for the time being control society, and adjust itself to the political structure of the particular society to which it applies*

a This fundamental truth, it will be observed, is presented in two separate statements, and it may be well in proceeding to its illustration to treat the statements in the order of their presentation. It is asserted, in the first place, that a financial system must conform to the political ideas which for the time being control society. Reference is here had to those broad, comprehensive views of individual and public rights which underlie social relations. Even a superficial study of history shows that the Roman State, for example, was actuated by political ideas essentially different from those of the Swiss Federation; that the fundamental conception of class relations, of public duties, of individual privileges, and the like, were not the same for the two peoples; and that the government of the former must have been upon an entirely different pattern from that of the latter. Every society has what may be termed its legal framework, which conditions all forms of activity, both public and private. This framework is found in the laws, or in customs more enduring than laws, by which the admitted rights of all persons, classes, or associations are definitely stated. Now it is a truism to say that financial regulations, the aim of which is to secure revenue for the

support of the State, should conform to the political ideas expressed in the constitution of society, for the financial system is in reality the fiscal expression of the social and political aspirations of the governing class. This may be clearly comprehended if some of the more salient points of two or three financial systems which history discloses are passed in review.

Most of the ancient states were founded on conquest, and the most conspicuous feature of their society was its military organization. The theory of rights and of duties which in modern times is conceded to apply in the same manner to all men was commonly in ancient societies restricted to the relation of freemen to freemen. No rights, social, industrial, or fiscal, were conceived to exist for a vanquished people as against the State. Revenue was largely in the form of tribute or arose from confiscation or booty. During the latter days of the Roman Empire, it will be remembered, one half of the booty went to the army, the other half to the civil government. In Athens during the days of her power three-fifths of the public revenue arose from tribute*. In the military organization of society the fiscal system will inevitably be military in character.

Following the fall of the ancient states a new principle of association made its appearance, and society took upon itself the form of feudalism. It will be futile to attempt to characterize the political ideas of the Middle Ages by a single phrase; but the fact of importance for the purpose of our present illustration is that government was proprietary rather than military in its organization. In theory all landed property, (and landed property constituted the bulk of all property known to the industries of the times), belonged to the king, who assigned it to his dependents in return for military service, who in their turn assigned it to their dependents in return for labour. The king retained for royal use an amount necessary to meet the needs of himself and household, and the feudal lords did the same in their respective manors. They and their households represented the *de facto* government, and performed all military and juridical service without making any regularly recurring demands upon the people. The State was chiefly supported out of the earnings of the

* Schönberg's *Handbuch der politischen Oekonomie*, B. III. p. 14.

property of those who represented the State, contributions from the earnings of individuals being at first of the nature of special assessments to meet special emergencies. It was a source of income which the feudal principle assigned to the State, and not the right to demand a portion of the income of citizens. One is not at liberty to assume that under such conditions no system of finance could have been developed. Both analysis and history would deny such an assumption. It is, however, correct to say that a feudal system of finance must conform to the requirements of a proprietary government, and that these requirements are essentially different in their form, and in their tests of success, from those which pertain to a military society on the one hand or to a democratic people on the other.

The principle of association which in the course of history followed the decay of proprietary government is what may be termed the political principle. Its development goes along with philosophic democracy, constitutional government, and private property. The conception of the rights of individuals and of the place of government in society is wholly changed from that which asserted itself in feudal times. Government is now conceived to be an agency to which certain definitely prescribed functions are assigned, and, like any agency, rightfully demands support adequate to the satisfactory performance of its assigned functions.

The chief personage in this adjustment is the citizen, in whom ultimately all rights rest, and for whom all privileges exist and all services are rendered. Private property is an essential part of this scheme of association, and it is to utter the most apparent truism to say that the financial system of a people whose ambition it is to realize the principles of political association must adjust itself to the requirements of constitutional government and to the demands of private industry. The financier is not at liberty to idealize his historical environment, for by so doing he will fail to realize a workable system. In this fact the Science of Finance finds a canon of judgment by which the propositions and plans of financiers or social reformers are to be tested. The first requisite of a financial system is to secure adequate funds for government, and to secure them in such a manner as to be least burdensome to the people. In order to do this the demands made

by a financial system upon the citizens of the State must fit into the accepted system of political, social, and industrial rights.

b. The second part of the third financial axiom is that *a financial system must adjust itself to the political structure of the particular society to which it applies*. For the elucidation of this truth attention may be confined to the various forms of constitutional government which at the present time exist. All of these governments are endeavouring to realize the same general idea of political and social rights; inasmuch, however, as they have come to this by various paths, it is no occasion for surprise to discover marked differences in their constitutional structure. This being the case, it is the duty of the financier in any particular country to acquaint himself with the facts peculiar to his own State, and while much may be learned from a comparative study of various financial systems, he will do well to confine his definite proposals to meet the peculiar conditions of his own historic environment. In all discussions of financial rules and principles it is essential that this limitation of their application should be recognised.

The most pertinent comparison to which reference may be made for the purpose of illustration is found in the marked contrast which exists between the fiscal systems of the German Empire and of the United States. Both of these peoples are endeavouring to realize constitutional principles. Both, also, so far as form is concerned, are Confederated Unions; yet so different is the history of these two peoples that little of a common character may be found in their respective financial systems.

By referring to American history it will be remembered that prior to the Revolutionary War the thirteen colonies sustained no important political relations between themselves. Each colony was dependent upon the mother country, and it was not until a common menace arose that they came to recognise community of interests. This appreciation of a common danger was the beginning of a national life which succeeded eventually in expressing itself in a fairly strong centralized government. At the time the independence of the colonies was formally recognised, however, so great was the fear on the part of the new States lest their political importance should be overshadowed by the central authority that

the government created to represent national interest was but a weak and halting affair. This was the government which rested upon the Articles of Confederation, and, as is familiar to every student, it was not granted adequate authority to protect the interests of the newly established nation. The particular difficulty encountered arose on account of the reserved right of the States to withhold financial aid. According to the theory adopted, the finances of the Confederation rested entirely on requisitions upon the States; the central government being, in consequence, deprived of any independent source of revenue. A government without revenue can, of course, show neither independence nor strength; and in the readjustment which took place on the occasion of the adoption of the present Constitution this weakness was overcome by granting to the central authority the exclusive use of customs duties as a source of revenue. With this exception, however, the States were left in undisturbed possession of all the sources of income which they had previously enjoyed. In this way it came about that the finances of the several States are not only entirely independent of each other, but are likewise independent of the Federal Government. The political theory to which the Constitution was adjusted recognised the States as the original sovereignties, and as still retaining all sovereign powers which were not expressly granted to the Federal Government when it was established. There is, consequently, no opportunity for any credit and debit account between the central government and the States, nor is it possible, except by means of agreement, to attain any harmony in the financial legislation of the States themselves. It is thus observed that, on account of the peculiar history of the American people, the financial systems of their several governments cannot easily become a uniform and harmonious whole; they are rather an aggregation of financial systems of separate and independent sovereigns.X

In Germany, on the other hand, different historical conditions have produced essentially different results. Here, as in the United States, the Imperial Government was created out of a union of independent States whose rights and duties as part of the Empire are definitely stated in a written Constitution. Under the peculiar historical conditions, however, at the time this union was effected, the jealousy existing be-

tween the States did not pertain to questions of revenue, and, consequently, the financial adjustments were such as commended themselves to judgment rather than to prejudices and jealousies. Moreover, the preponderance of Prussia in the Confederation, whose king was declared to be the hereditary head of the Empire, rendered it safe for the Imperial Government to allow to the respective States certain financial rights which could not have been allowed had the States making up the Empire been equal in population and area. When, therefore, it is learned that the financial system of the German Empire is one which incorporates the theory of requisitions, which maintains a debit and credit account between the Imperial Government and the States, and in which the officers who collect the Imperial revenue are State officers, one can easily appreciate how this adjustment is natural in view of the historic conditions under which the Constitution was formed. It is considerations of this sort which lead to the assertion that a financial system must be judged in the light of its relation to the past of the nation to which it applies. A question of financial adjustment is always at last analysis a constitutional question.

As another illustration of the same thought, reference may be made to the ratio of local and central expenditure in the various governments of the world. In the United States, for instance, sixty per cent of all public expenditures are local or non-Federal expenditures, while the local expenditures of France are less than thirty per cent of the aggregate. No fact could more clearly indicate that the administrative structure of the former is essentially different from that of the latter. Differences of this sort are familiar to the student of comparative finances, and the more extensive his investigations the more pronounced will be the impression that the first duty of a financier is to know his own people. The political and social ideas of the time are for him given factors; they are elements in the problem he undertakes to solve. It will not do for the financier to fail in his appreciation of historic perspective, or to ignore the very narrow and limited margin of choice which at any particular time is presented to him. It is such considerations as these which lead one to assert that the third of the fiscal axioms which have been presented cannot be safely disregarded: *A financial system must*

conform to the political ideas which for the time being control society, and adjust itself to the political structure of the particular society to which it applies.

3. The Nature of Public Wants.—A consideration of the nature of the State has led to certain fundamental truths which financiers cannot disregard. The second step in the unfolding of our study is to inquire respecting the nature of the wants of the State, to supply which is the aim of a financial system. It is not necessary in discussing the wants of the State to enter upon any abstruse or metaphysical analysis. The meaning of the phrase lies wholly upon the surface, and suggests itself at once when it is recognised that the State must always be represented on its formal side by a government, and that government stands forth in the person of the individuals who represent it. Indeed, no error can arise should the Science of Finance conceive of the State as a corporation intrusted with the performance of certain delegated functions. It comes then to be a legal personality, the same in kind, though not in the nature of its powers nor in the motives which control its conduct, as any other corporation, and its wants are of quite the same sort as those of an ordinary business concern. By conforming to such an idea our subject takes upon itself that simplicity and clearness essential for just conclusions. Much of the profundity of thought which many profess to discover in this science is in reality foggy thinking, and arises from the proneness of publicists to dally with metaphysical conceptions.

(1) *Public Wants Are Reducible to a Demand for Money.* - The wants of the State vary from time to time, but, confining our analysis to peoples familiar with constitutional government and with the institution of private property, they are, as already remarked, the same in kind as those of a corporation intrusted with the management and development of an extensive business. That is to say, the State needs to own a certain quantity of land and to control a certain quantity of labour or service.

Since the principle of feudalism gave place to the principle of representative government, the amount of land which must be placed at the disposal of the State has greatly decreased. It is only necessary that the State should own, or directly control, a sufficient amount of land to serve as standing

ground for the performance of its delegated functions. The land owned by modern governments is used chiefly for such purposes as building sites, forts, navy-yards, public parks, and the like; wherever an exception to this rule appears, it may be regarded as evidence that some of the old feudal forms are yet maintained, or that society is adjusting itself to the ideal of socialism. Either of these conditions is out of harmony with what has been characterized as the political principle of association.

Not only is the amount of land required by the modern State limited to what it can directly use for governmental purposes, but in securing this land the government resorts to no unusual method of procedure. It buys its land in open market, in the same manner as a private person. It is true that in the theory of English law the title of all land is held from the State, and that the State can exercise in its own interest the right of eminent domain; but an industrial corporation also may secure for itself the exercise of that right if it can show that the land is to be used for a public purpose. It thus appears that the demand for land is reducible to a demand for money. Land itself has ceased to be a distinctive element in the financial policy of the State, a fact which will be more clearly seen when, in a subsequent part of this study, the policies of modern governments respecting public domain are considered.

The second requirement of the State is control over labour or service. The State stands forth in the person of public officers or employes who, giving their time to the public service, must be supported at the public charge. Here, as in the case of land, political government is in bold contrast with proprietary government. In the feudal system public services were rendered by the governing classes without specific payment for definite service. The theory seemed to be that a definite amount of property was set aside for the use of those rendering governmental or social service. At present, however, the greater portion of productive property having been assigned as the property of individuals, and being used as the source of personal profit, the State is obliged to pay for the labour of those who render public service in the same manner as a private corporation. This means that the second great want of the State, namely, the want of service and

labour, is for the most part reducible to a demand for money.

(2) *Consideration of Gratuitous Service*—While it is true that money payment for public service is the general practice among modern governments, the exceptions to this rule are sufficiently numerous and important to deserve special consideration. The relative merits of gratuitous and coerced services on the one hand and of paid service on the other may yet be regarded as an open question, so far as a few classes of public duties are concerned. As an illustration of gratuitous service mention may be made of the custom, so common among the smaller cities of the United States, of attaching no salary to the office of mayor. Regents of State universities, trustees of asylums, boards of visitors of public institutions, and in general all who render public services of an analogous nature, place their time and skill at the disposal of the State without pecuniary compensation. Sometimes this so-called gratuitous service is in reality a coerced service, as for example in those cantons of Switzerland where citizens are obliged by law to accept office, for at least one term, if elected thereto. Yet another illustration of gratuitous service is found in the English custom of withholding salary from members of Parliament.

The motives which induce men to serve the public without pay are various. In some cases it is the honour or social distinction attached to the office, or the satisfaction of one's ethical instincts. It is possible also that incidental benefits accrue to the holder of office, such as the expectation of political preferment or the control of government machinery for personal or class ends. But whatever the motive may be, provided an exception be made for boards of management of semi-philanthropic institutions, it is believed that gratuitous service is inconsistent with either efficient government or the most equitable administration of public affairs. The reasons for this opinion are four, and as follows :

First. The motives which impel men to render gratuitous service are not constant and persistent, and consequently reliance cannot be placed upon them for the most efficient public service. Patriotism, under the impulse of strong excitement, is capable of effecting prodigious results, but it is apt to die away with the occasion which brought it forth. While,

therefore, it may be wise in times of exigency to appeal to this motive for securing service, it cannot be accepted as a basis for rendering continued service. A sense of honour and a desire for social recognition are more reliable as main-springs of conduct than patriotism, but even these are not able to endure a long-continued strain. They generally come to men late in life, and their force weakens with the possession of the honours sought. Honour and social distinction, like patriotism, are limited to a comparatively narrow range of services. It may be conceded that ambition is more persistent than the desire for social distinction, but a consideration of the manner in which it works shows that it exercises greater power in the securing of an office than in the performance of the duties of the office when secured. For this reason it cannot be accepted as an adequate basis of governmental service. The only constant and persistent motive, the only motive which works all the days of the week and is of about the same strength throughout the years, is the purely economic motive; that is to say, the desire for income. An analysis of motives surely warrants the conclusion that the demand of the State for service may, with few exceptions, be reduced to a money demand.

Second. It is essential in a good scheme of government that a public officer should be held to strict responsibility for the manner in which he performs the function of his office, and this it is impossible to do if he renders gratuitous service to the public. He will not feel that there is anything personally at stake in the manner in which he performs public duties, nor will the public be very stringent and exacting in its demands upon him. If, however, an officer be paid for his service so that he relies upon it for an income, the work which he performs appeals to him in the same manner as that of the physician, the merchant, or the mechanic; and the public also regards itself at liberty to hold the incumbent of an office to a high grade of efficiency. This second argument against gratuitous service may be summed up in the adage: The more business and less courtesy in public affairs, the better the government.

Third. A third consideration against gratuitous service is found in the fact that such service can never be a trained service. In so far as public service is rendered without pay,

it must be rendered by men who have already secured a competency. This means that the majority of public servants must be men of advanced years, and men who have spent the period of life commonly devoted to education in making preparation for work entirely different from that demanded by the State. Gratuitous service, therefore, means that the government must educate its officers after it has taken them into its employ, which is not only expensive in itself, but must lead to an inferior grade of service. From this it appears that the so-called gratuitous service may in the end prove to be a very expensive service. In applying this argument, however, one should hold in mind the administrative rather than the legislative functions of government.

Fourth. The final thought against gratuitous service pertains primarily to legislative functions, and springs from the fact that, by excluding from the service of the State all who have not acquired a competency, the danger is incurred of placing the machinery of government at the disposal of the wealthy classes. This suggests the principal argument for the payment of members of Parliament in England. It is claimed that failure to make pecuniary compensation for the services of legislators excludes the labour interest from any representation in the law-making body, since they who clearly understand that interest cannot afford to give their time to legislative functions. Speaking generally, though there are of course many exceptions to this rule, one who is anxious to serve the public gratuitously in any important place of honour and trust comes justly under the suspicion of desiring the office for personal ends. From all these considerations it might easily come about that gratuitous service would be gratuitous in name only. The rule that public service should be a paid service admits of few exceptions.

(3) *Consideration of Coerced Service.*—So far as coerced service is concerned, there is a pretty well defined practice among modern peoples. The existence of the State is conceived to be of more worth than any of the personal rights of citizens, and, provided political necessities warrant extreme measures, the State is at liberty to exercise its power of coercion, even to the extent of demanding that a subject place his life in jeopardy for the life of the State; and it depends entirely upon the military policy whether reliance is

placed upon a volunteer service with the reserved right of draft in case of emergency, or whether a labour tax is imposed upon a people for the support of a permanent standing army. In either case, however, no invidious discrimination is allowed as between citizens. The coercion of military service must be according to some general law.

Germany presents a good illustration of a military organization based upon the exercise of coercive power. All male citizens, with some few exceptions which need not here be mentioned, are obliged to serve three years in the standing army and to remain for twelve years longer as a part of the army reserve. That is to say, Germany imposes a special labour tax for the purpose of procuring military service, and consequently is exempt from the necessity of imposing as large a money tax for the support of the army as would otherwise be the case. The merit of this system, regarded from a financial point of view, depends very largely upon the relative burdens of a labour tax on the one hand and a money tax on the other, as well as upon the incidental benefits which accrue from the two plans of military organization.

The other system of procuring military service is through money payments to volunteers. This system is followed notably by England and the United States. In ordinary times those who enter the army do so because they find here a profession or calling which is suitable to their tastes. In the United States, where the volunteer system is applied most extremely, a military emergency is met through an appeal to patriotism or by the use of the draft. It is true that all enlisted men are placed upon the pay-rolls of the army, but, with the exception of those who are induced to enlist in times of peace, this pay cannot be regarded as a fair compensation for the service rendered. Those who enlist through patriotism are rendering a partially gratuitous service to the State, while the service of drafted men is a coerced service. It seems, then, so far as military organization is concerned, that the State is obliged to rely more or less upon its sovereign power of coercion. From an economic point of view there is little question that the labour tax, as practised by Germany, rests more heavily upon the industries of the people than a corresponding money tax. It is equally certain that the considerations of military efficiency would lead to an acceptance

of the German system. The extent, therefore, to which it is wise for a people to rely upon an exercise of coercive power in the maintenance of its military system depends upon the relative importance of industrial and military excellence, and this in its turn is very largely a matter of geographical situation and political conditions.

The conclusion to which this consideration leads is, that military service presents something of an exception to the rule that the demand for labour by the State is reducible to a money demand.

Another illustration of coerced service is found in the practice followed by many States of calling upon individuals to devote a certain number of days to work on the public highways. This is called the "road tax," and is, in form at least, a labour tax, although it may be commuted into a money payment. Experience shows this procedure to work badly in every way. No systematic improvements are possible under it, since each man insists on paying his tax to the public by working upon the roads adjacent to his own property, and, like all community work, it is rendered without care and without responsibility. For working out the tax these days are selected which cannot be used for any other purpose, and the uniformly bad condition of the country roads in many parts of the United States is an evidence of the inadequacy of coerced service in the maintenance of highways.

A third illustration of coerced service is found in the jury system as practised in the United States. A small *per diem* payment, it is true, is allowed to jurors, but the universal desire to escape this service shows the payment to be no inducement. From the nature of the case, however, it is essential that courts should be granted the liberty of enforcing this service, since it would be impossible otherwise to carry on the jury system.

In conclusion, it may be said that, with the few exceptions named, and others allied to these in principle, the demand of a State for labour or service is, like the demand for land, reducible to a money demand; and our investigation may proceed on the assumption that what the State wants for the satisfactory performance of its duties is control over an adequate money supply.

4. General Divisions of the Science of Finance.—It remains for us to consider in this introductory chapter the nature and scope of the specific class of questions which claim the attention of the Science of Finance. As was remarked in connection with the definition of this science, all questions which find proper place in finance pertain either to the determination of the legitimate and necessary fiscal wants of a State, or to the manner in which those wants may be the most economically and justly supplied. Our science divides itself into two parts, along the lines thus marked out. Part I concerns itself with Principles of Financial Legislation and Administration, and will be treated under the two heads of Public Expenditures, and Budgets and Financial Organization.

Under Part II will be found an analysis of the Source of Public Revenue, which leads to a separate consideration of Public Property, Taxation, and Public Credit.

A study of the source of public revenue comes naturally into the Science of Finance. Indeed, most English writers have contented themselves with a consideration of this part of the subject, and have commonly entitled their treatises *Taxation*,^{*} *Taxation and the Funding System*,[†] and the like. It may be a little more difficult to perceive with clearness the steps by which the theories of expenditure, the considerations of budgets and budgetary legislation, and the rules and principles of financial organization are brought into the domain of this science, or, if the mind easily admits a consideration of these questions, the limit to which they may be properly carried is not so easily determined. For this reason it may be well to explain somewhat in detail these lines of investigation and the manner in which they are introduced.

A slight knowledge of public affairs makes it evident that a person or a party intrusted with the exercise of governmental power is subjected to certain peculiar temptations that present themselves in connection with financial administration. There is, in the first place, great danger that the government will demand money for the purpose of performing services which may be performed better and more cheaply by individuals. Such a demand would result in an unwar-

* Peto.

† McCulloch.

ranted increase of public revenue. Closely allied with this is the danger that excessive demands for money may be made by government for purposes which are approved. This is no evidence of corruption on the part of legislators, nor does it imply that they intentionally make excessive demands. It is evidence rather of carelessness, or of ignorance of the consequences bound up in a given vote. It is an inevitable result of the transaction of business by a large body of men. The remedy open to the citizen against wrongs of this class, except in case of constitutional or legal provisions which limit the amount of taxation, is the political remedy. He is at liberty to cast his vote against the party representing the government guilty of an undue demand for money, and, in order that he may exercise this political remedy wisely, it is essential that the general principles of public expenditure should be clearly understood. How far is a government justified in encroaching upon the income of citizens for the purpose of the public service? What relation has public expenditure to the stage at which a people have arrived in their social, political, and industrial development? Are there any fundamental principles of expenditure which may be used as canons of judgment? What in general are the facts of public expenditure? What have been the movements in the past and what are the tendencies at present? These and other questions of like sort must receive consideration before one can judge correctly what proportion of the actual income of a nation may be legitimately demanded by the government. It seems, therefore, that because of the temptation to over-expenditure on the part of the government—which history declares to be an ever-present temptation, and since the only method of guarding against undue demand for revenue lies in an enlightened public sentiment, an analysis of Public Expenditure finds easily and naturally a place in the Science of Finance.

There is also danger that the methods adopted for raising the necessary funds will not be in harmony with the demands of sound economy, and that the revenue system will in consequence disturb the orderly industrial development of the nation. The second fiscal axiom would in this manner be disregarded, for such a revenue system would tend to impair the patrimony of the State. The dangers here brought to

view are such as are incident in the passage of money bills. They cannot be controlled to any great extent by statutory enactment. Much, however, can be done to avert the dangers thus brought to light if the legislative body, before taking up any specific question of expenditure, lay down such rules of parliamentary procedure as will insure adequate study of all financial measures and render ignorance on the part of any legislator respecting the consequences which follow upon his vote a political crime. In this manner the danger of ill-advised financial legislation will be lessened. A consideration of such parliamentary rules constitutes that chapter in the Science of Finance which passes under the name of Budgets, and the propriety of including budgetary legislation in this study is thus rendered apparent.

The third danger to which the public is exposed in connection with financial administration is found in the fact that money properly appropriated may be lavishly expended. No mention need be made of the temptation to theft always presented to men in control of large expenditures, nor of the fact that the accounting departments of government must provide means of detecting such an offence. As in the case of appropriations, the chief danger lies in the carelessness of public servants, and in the desire of men intrusted with office to magnify their personal importance by increasing the amount of money placed at their disposal. It is the weaknesses of officials rather than their criminal inclinations that result in lavish expenditures, and it should be the aim of a well-organized financial administration to provide for the sure exposure and quick punishment of an injudicious or careless use of public funds. In no other manner can the fundamental requisite of a sound financial system be realized, namely, that a service rendered by government should be rendered at cost.

From the foregoing analysis we arrive at the following conclusions:

A theory of Public Expenditures finds place in the Science of Finance because of the danger to which the public is exposed that the administration will make excessive and unnecessary demands upon the incomes of citizens.

Budgets and Budgetary Legislation are included in this

investigation because established parliamentary methods are essential to an intelligent vote upon financial questions.

A consideration of Financial Organization is necessary to a comprehensive investigation into public finances because established rules of procedure and an appropriate administrative organization are necessary for the successful execution of fiscal laws. In a comprehensive treatise this might properly be made the subject of an independent investigation; in this essay, however, it is presented as the concluding chapter of budgets and budgetary legislation.

Part I of this treatise is divided into two books:

I. Theory of Public Expenditures.

II. Budgets and Budgetary Legislation.

PART I.

PUBLIC EXPENDITURES.

BOOK I.

THE THEORY OF PUBLIC EXPENDITURES.

CHAPTER I.

CONCERNING THE NATURE OF PUBLIC EXPENDITURES.

THE POINT OF VIEW FROM WHICH PUBLIC EXPENDITURES SHOULD BE
REGARDED

- (1) The Individual Point of View.
- (2) The Collective Point of View.

THE APPROPRIATE METHOD OF INVESTIGATION.

THE purpose of a study of public expenditures is to discover the meaning of expenditures through the agency of the State for the life of the people, and in this manner to arrive at those general principles which control governmental appropriations. Some of the considerations which present themselves in this connection have been recognised by writers upon finance in their treatment of the just limits of taxation, but there are many reasons why the class of questions which lie in controversy may be more advantageously approached from the side of appropriations than from that of taxation

The general principles disclosed by a study of public expenditures cannot be formulated into definite rules of administration; this, however, is no reason for regarding them as unimportant, since they will prove to be of assistance in defining the several points of view from which appropriations may be considered, and in this manner lead to an adjustment of the

nation's finances in harmony with the political aims and social theories accepted by a people. This remark seems necessary in order to curb somewhat the expectation of the student that the conclusions of this investigation into public expenditures will be of a very definite or explicit character. For the purpose of guarding against an ill-advised use of public moneys, whether in the form of extravagant appropriations or of equally extravagant parsimony, reliance must be placed upon what has been termed the political remedies for public abuses, and, as has been already remarked, it is essential to the efficient working of this remedy that the people be informed upon all matters pertaining to the use of public moneys. The analysis that follows may be regarded as a contribution to the formation of an efficient public opinion.

5. The Point of View from which Public Expenditures should be Regarded—The question which arises at the threshold of this investigation pertains to the point of view from which public expenditures are to be regarded. Shall the experience of the individual in the expenditure of his private income be accepted as pertinent in considering the fiscal operations of the State, or does the nature of the State differ so radically from the nature of the individual that considerations which may properly influence the one are necessarily foreign to the interests of the other? Upon this point there does not seem to exist any harmony of opinion among writers on finance. The tendency at the present time is to emphasize the differences which exist between individuals and the State, and to assert that the experience of the individual is of little use when the broader questions of public economy are under consideration. While agreeing substantially with this point of view, so far at least as to recognize that much the larger number of practical questions in public expenditure rest for their proper understanding upon the fact that the State represents a collective and permanent rather than a personal and terminable interest, it is readily admitted that the arguments which naturally spring from it may be applied with such rigour as to lead to decidedly erroneous results. Although the State in its fiscal operations must follow rules imposed by its own nature, this should not blind one to the fact that the government does not exist in and for itself. Questions of public expenditure are not to be judged independently, but rather in the

light of the relation which public activity holds to private activity. So important is this consideration for a proper understanding of the subject that we may pause for its more perfect elucidation.

(1) *The Individual Point of View*—The most common as well as the most crude form of presenting the thought that the financier has little or nothing to learn from a study of domestic expenditures is found in the statement that the individual adjusts expenditures to income, while the State adjusts income to expenditures. In a sense this is true, but the impression which it leaves is hardly tenable. It is true that the State, being a corporate personality, has no pecuniary needs except such as are required for the performance of its delegated functions. It is true also that in order to perform the services assigned the government must be placed in possession of a definite amount of income. But it must not be forgotten that the general income of the people, from which the income of the State in large measure arises, should as a matter of right and does as a matter of fact exert a decided influence upon the extent and character of the functions which the State may undertake. The government of a wealthy people may very properly enter upon services calling for increased revenue which would not be defensible in the case of a poorer people. It thus appears that for public expenditure as well as for private expenditure there does lie back of the question of the amount that may be economically assigned the conception of a fund of wealth out of which payment must be made. Public appropriations are limited by the relation which they hold to the amount of wealth at the disposal of the people, or, to express this in another way, to the productive capacity of a nation's industry, including public as well as private industry. It is the social income rather than the governmental necessities which must be accepted as a starting-point for a theory of public expenditures.

This general thought is expressed in another way, and much more profoundly, by Stein. After some general observations of the relation of public finance to public economy, he proceeds to criticise the statement that the ruling consideration in the Science of Finance is that the fiscal demands of the Government should be complied with without question; or, to employ the author's German phraseology,

that the ruling principle in the Science of Finance is the covering of the wants of the State. This assertion, he affirms, is not true. "The ruling principle is rather that, in covering the needs of the State, a due proportion be maintained as compared with the proportionate covering of those needs not represented by the State. Public economy (*Staatshaushalt*) is a branch of social economy, — one of the most important, it is true, but nevertheless a branch. There is no sovereign principle in the Science of Finance separate from the general principles of Political Economy and Social Science respecting the proportionate covering of governmental and non-governmental, collective and individual, necessities. The financier who appreciates only public needs will undoubtedly declare them to be sovereign. In this he proceeds no less from the atomic and anti-social point of view than the bugher who, under all conditions, aims to limit the State to the crumbs left over from the domestic budget. Considered by itself, the starvation of private or non-governmental needs through a gluttonous public economy is as strictly forbidden as the spoliation and disintegration of the State through a parsimonious egotism. . . . Neither public nor private economy presents, of itself, a final end. To pamper the one and starve the other, to over-nourish the one and stunt the other, appears, upon its face, without warrant, since an effective State and a strong people are alike essential elements in national life. Both public and private needs are integral parts of a common necessity, and the one as well as the other must finally be determined according to their relative importance for the maintenance and development of society as a whole. . . . To provide for public necessities as well as for private wants, in the ratio of their relative economic importance, is the manifest, self-apparent demand which the theory of finance that holds itself within the circle of economic vision asserts as its own, and which may be successfully opposed to the parsimonious citizens as well as to the spendthrift State."

From the reasoning of the above paragraph, quoted freely from Stein's great work on Finance, and this treatise grants it most hearty approval, it appears that the point of view from which public expenditures are to be regarded is neither that of the individual nor of the State, but rather that of the col-

lective life of the community. The starting-point is the fund of wealth at the disposal of the nation, the objective point is the highest development of both individual and national life, the problem is to so balance the assignment of expenditures between the many various forms of consumption that the life of the people shall be nourished and the organs of the nation developed, at the point where nourishment and development are most needed. The ideal is that of a vigorous, well-rounded, uniformly developed social organism, and, provided the student can image to himself the unity of social interests, a decided advantage may be gained by applying to public expenditures the experience of the individual with a limited income.

It thus appears that so long as discussion is confined to the fundamental conditions which determine the aggregate of money rightfully placed at the disposal of government, more assistance may be derived from a consideration of the points in which private and public expenditures are alike than of the points in which they differ. With regard also to the balancing of the amount to be expended between the various lines of service entered upon by the State, the experience gained in the management of the domestic budget may be of decided advantage in the consideration of public finances.* As a larger percentage of the income of the poor man is expended on the necessities of life than on the comforts or luxuries, so a poor State will be called upon to make larger relative expenditures for the primary governmental functions than for those which come at a later stage of its development. The same considerations, therefore, which lead the economist to include an analysis and classification of private wants in his study of the theory of consumption require the financier to assign an important place to the analysis and classification of the activities of the State in his theory of public expenditures. It is not too much to say that the rule adopted for determining public expenditures is the financial expression of

* This point of view is fairly well supported by Bastable, who says "Without pressing the resemblance too far as is sometimes done, we may accept the evident fact that the State organization has certain points of view in analogy with the arrangements of the individual, and that in regard to economic action the comparison is particularly close." *Public Finance*, 2d ed., p. 37.

the sociologic theory of the development of governmental functions.

(2) *The Collective Point of View*—One cannot proceed very far, however, in the study of the financial side of public administration without observing certain marked differences between public and private financiering. Thus, in the first place, it may be noted that the individual or corporation whose primary aim is to reap a profit from an investment will be debarred from many lines of expenditure which a government may properly enter upon. Two reasons may be mentioned in explanation of this fact

First It is necessary for an individual to consider an investment as more or less temporary in character. His expectation of life is readily calculated, and on this account he is debarred from contemplating investments that run in perpetuity. The State, on the other hand, as has already been pointed out, enjoys the expectation of perpetual existence, and consequently is at liberty to judge of an investment from this point of view. In the matter of education, for example, the State may with propriety consider the ultimate and final effect of expenditures, not confining itself to the immediate demands for instruction measured by what the people would be willing to pay for if education were a private affair. To say nothing of the necessity of general intelligence for the realization of popular government, or because of its bearing upon the character of society, it must be regarded as a sound investment for the State to undertake the maintenance of the most advanced education, even going so far as to provide support for scientific research of all sorts and for art education; for it is certain that every true discovery and every talent developed will sooner or later find their place in the economy of industry and react upon the life and aims of the people. Such a view is, from the nature of the case, foreign to the individual who, conscious that life is fleeting, is constrained to judge of every investment on the basis of proximate rather than ultimate results.

Second An individual is under the necessity of providing for a quick return upon his investment in order that he may maintain the credit of the enterprise in which he is engaged; while the State, whose credit does not rest entirely upon the fact that money appropriated comes to be the source of defi-

nite income, may be rightly influenced by considerations of ultimate rather than immediate gain. It cannot be expected, for example, that an individual will develop a system of forestry, since the investment must continue for at least thirty years before it begins to return a profit, and this is a longer period of waiting than an individual cares to contemplate. It is true that a certain amount of value would accrue each year on account of the growth of the forest, but since the system of bank discounts has not yet sufficiently developed to enable this increment to be transformed easily into an annual income, forestry is not attractive to the ordinary investor. The State, however, to whom thirty years is but a period in thought, would be justified in investing large sums in forestry, provided the growing of trees is itself of public advantage and the ultimate outcome of the investment reasonably sure. Its credit during the period in which the investment is unproductive rests upon its power of securing revenue by taxes, and the government is, consequently, able to secure capital for the establishment of forestry at the lowest possible rate of interest. Many other cases might be cited to make clear the differences which exist between public and private investments on account of the fact that the State, unlike the individual, enjoys a perpetual lease of life. These two, however, education and forestry, are adequate to make clear the principle laid down.

It should be noted in the second place, as indicating a further difference between public and private expenditures, that a different interpretation is given to the phrase "profitable investment" by the individual and by the State. In the judgment of the individual a profitable investment is one that gives rise to money profit. The income account must show a surplus. The stocks must secure dividends, the bonds bear interest, and both dividends and interest must arise from the earnings of the business created by the investment. The State, on the other hand, regards an expenditure as productive which results in the creation of those social, political, or industrial conditions essential to the efficiency of private enterprise. Although the profit arising from such an expenditure accrues directly to the individual, the expenditure is justified if the industries of the country are thereby raised to a higher grade of technic, or if labour is rendered more productive in consequence. The State exists for its citizens, and

its chief service is to provide conditions under which the activities of citizens may prosper. But the State receives also pecuniary advantages from such investments, for, although the increment of profit appears in the first instance upon the income account of private industries, the Government enjoys, as the result of its investment, a larger source of revenue through taxes than would otherwise be the case.

There are many illustrations of expenditures which, while unproductive when regarded from the point of view of the individual, come to be in the highest degree productive when the fact that the State represents the collective interests of society is held in mind. All general improvements, for example, like the dredging of streams for navigation, the building of wharves, docks, and the like, the encouragement of great public works which would not otherwise be undertaken, may be for the State a most profitable investment of capital. All expenditures necessary to create and maintain a condition of safety for persons and for property are included under this head. Thus, Italy found it necessary, a few years ago, to make unusual expenditures in order to rid the country of lawlessness and violence; but this has been repaid many times to the government, and a hundredfold to the citizens of Italy, in the expansion of the new industries which the unusual security called into existence.

Our general conclusion, then, respecting the point of view from which expenditures are to be considered is the following: Since the State is the people organized in their collective capacity, and consequently the wants of the State are in reality the wants of the people whose servant the State is, a very large number of the questions respecting public expenditures are found to be, upon final analysis, questions which have to do with the collective expenditures of individuals, and on this account should be judged in the same way as an individual judges of his personal expenditures; but, on the other hand, in view of the fact that the State is an organism of perpetual life, that it is imposed with responsibilities which extend beyond the interests of individuals or classes, and, also, that it is clothed with unusual powers for carrying through the duties imposed upon it, there are, in addition to the considerations respecting expenditure which it holds in common with domestic economy, other considerations which arise on ac-

count of its peculiar functions and public character. The point of view, therefore, from which public expenditures are to be regarded changes with the nature of the questions under consideration; and one of the chief difficulties in the solution of fiscal problems of this class is found in the necessity of bearing constantly in mind these two avenues of approach.

6. The Appropriate Method of Investigation—Having decided upon the point of view from which public expenditures are to be regarded, it seems proper to inquire next respecting the most appropriate method of investigation. Ordinarily one is willing to rest the approval of his method upon the success of his analysis, and this undoubtedly must be the final test. In the present instance, however, the conditions under which the investigation is undertaken, as well as the character of the problem, are somewhat peculiar, and an explanation of the method adopted will throw added light upon the nature of the question in hand.

It is not designed, in our effort to arrive at the social law of public expenditures, to make any considerable use of statistics, either for argument or illustration. On the contrary, our chief reliance will be placed upon an analysis of social needs and upon an investigation into the order followed in the development of State functions. This may at first sight appear strange, and it is somewhat unusual. The larger number of writers who have seriously and intelligently considered the problem of public expenditures¹ proceed, after a cursory statement of public functions, by means of statistical inquiry. They succeed, doubtless, in pointing out some of the current tendencies in public expenditures, but they fail to place those tendencies in their proper setting or to deduce from the facts collated any satisfactory statement of the law of social development as reflected in public accounts. An investigation which begins with figures is likely to end with figures.

Speaking more definitely, there are two reasons why, in the present condition of fiscal science, an investigation into public expenditures must take upon itself the form of a theoretical investigation. The first of these reasons is a very practical one. The statistics of public expenditures are un-

* A running comment on the cost of governmental functions, accompanied by academic advice to statesmen, is not acknowledged as a serious or an intelligent appreciation of the problem.

satisfactory when regarded as material for synthetical analysis. This is not due to paucity of material, but to the fact that governments keep their accounts in different ways, and that the phrases employed in public accounting do not always cover the same items in expenditure. It is natural that this should be the case. Public accounts are necessarily organized in conformity to the administrative systems of the various states; and these in their turn are adjusted to the several theories of political organization, as also to the governmental policies which for the time being control administration. This marked divergence in the accounting systems of the several states places an estoppel upon anything like a comparative study of public expenditures beyond the most rudimentary and broadly conceived classifications. Even a service of such long standing as the "military service" does not mean the same in all states when translated into the language of expenditures. Should one undertake a study of the comparative cost of judiciary systems, he would find the problem complicated by the marked divergence in the matter of fees and by the different ways in which fees are accounted for. In some cases a fee is a net return; in others it is a gross return. In some cases no account whatever is made of court fees to the public treasury. The true cost of the judiciary in the United States, for example, cannot be ascertained, to say nothing of comparing it with the corresponding costs in other states, or of discovering a tendency with respect to this item of expenditure by a study of judiciary accounts from year to year.

The chief difficulty, however, in a comparative study of public expenditures is not found in the divergence of accounting systems followed by those governments which are imposed with national or sovereign functions. We might, perhaps, get along with the federal, or imperial, or ministerial accounts of the several states; that is to say, with expenditures for national or sovereign purposes; a more serious embarrassment arises when to these accounts there are added the accounts of the subordinate or local governments. What lesson, for example, can be learned from a comparative study of the expenditures of the French Republic and the Republic of the United States when it is remembered that sixty per cent. of the aggregate of annual expenditures on the part of government in the latter case is through

the medium of local governments as against thirty per cent in the case of the French Republic ? Duplications also must be guarded against by him who undertakes a comparative statistical study of public expenditures. In this country, for example, the accounts of each government are separate and distinct, but in Germany there is maintained a debit and credit account as between the Imperial administration and the several States that together make up the Empire. A portion of the expenditures charged to local government in France, also, goes, not uncommonly, to cover deficits in national expenditures.

Not only must care be taken to avoid duplication in arriving at aggregate public expenditures, but errors are likely to arise by failure to recognise the incidental ways in which payment is made for public service. What light, for example, can be thrown on pension payments by comparing the pension accounts in Germany with the corresponding accounts in the United States ? The police force in German cities is made up in part from the ranks of retired soldiers, provision being made for their employment as a partial substitute for the pension. In France, also, the tobacco-shops are not uncommonly tended by public pensioners. In the United States, on the other hand, the pension is a cash transaction.

Such are a few of the many illustrations that might be given of the difficulties encountered by one who approaches the question of expenditures through a comparative study of financial statements. A comparative study of the cost of the various branches of public service as recorded in the accounts of the leading nations is a most difficult task, indeed, it is a task of such proportions that years of patient investigation would be required for its successful accomplishment. To undertake a statistical investigation of this sort in an elementary treatise upon the Science of Finance would distort the proper proportion between the several parts of the treatise. This is the first and practical reason why, in the present treatise, no extended use is made of facts and figures in investigating public expenditures.

The second reason why reliance is placed upon analysis rather than upon the tabulation of statistical data is found in the present condition of the investigation itself. The service rendered by an adequate working hypothesis in the develop-

ment of any science is familiar to all students, and the reason now urged for considering the theory of public expenditures in advance of the formal study of the statistics of expenditures is found in the fact that the former is essential for the successful prosecution of the latter. The sociologic significance of appropriations for the support of government presents a problem that has never received adequate attention from economists and financiers, and it is necessary, in view of the present condition of the Science of Finance upon this point, to formulate an hypothesis respecting the movements in governmental expenditures before an intelligent investigation into public accounts can be undertaken; and the author ventures to express a hope that a consistent theory of public expenditures having been set forth as a general theory of social evolution, it will prove to be of sufficient interest to claim the attention of many students, and that at their hands it will be expanded and modified so as to become eventually an established generalization in the science of which it is a part.

It is not intended to leave the impression, by this apology for theoretical rather than statistical analysis, that the general conclusions arrived at are of use only as a working hypothesis for statistical investigation. They have a value of their own, and claim confidence even before they are proven to be true in all their parts. The elements common to civilized nations are those historic factors and forces that make modern life what it is. And it is these factors and forces, rather than the administrative form assumed by them and which secures for them a definite statistical expression, which *determine* public expenditures. A theory of public expenditures must consequently be built upon an intelligent appreciation of social forces and an adequate perception of social tendencies—an observation which justifies the procedure adopted by this treatise of building up a theory of public expenditures from those known and manifest features common to the social and political organization of all peoples whose government conforms to the constitutional type.

From this chapter we have learned the point of view from which public expenditure should be regarded and the method by which the investigation is to be undertaken. The chapter immediately following concerns itself with an analysis of those conditions and forces which determine the aggregate of the funds properly placed at the disposal of government.

CHAPTER II.

RELATION OF PUBLIC EXPENDITURES TO INDUSTRIAL, POLITICAL, AND SOCIAL CONDITIONS.

PUBLIC EXPENDITURES AND INDUSTRIAL DEVELOPMENT.

PUBLIC EXPENDITURES AND POLITICAL CONDITIONS.

(1) Expenditures and Political Environment.

(2) Expenditures and Political Organization.

PUBLIC EXPENDITURES AND SOCIAL ORGANIZATION.

TWO RULES OF PUBLIC EXPENDITURE

(1) The English Conception of Expenditures.

(2) The German Conception of Expenditures.

(3) Conclusion

It is the purpose of this chapter to trace the influence of the industrial, the political, and the social conditions of a people upon the aggregate of their public expenditures. Each of these elements of a civilization works in a manner peculiar to itself, and for that reason each may be made a topic for separate analysis.

7. Public Expenditures and Industrial Development.—The expenditures of a government may properly be regarded as the complement of private or non-governmental expenditures. Both are charged to the general social income, and for that reason the amount placed at the disposal of government for the purpose of carrying on the public service must be determined in view of the industrial development of the nation which gives rise to that income. It is the percentage of public expenditures to the gross income of society that provides a basis for judging the fiscal claims of a government. It is the ratio of the amount consumed to the fund by which consumption is supported that measures the intensity of a given demand. This being the case, it is clear that a demand for a public service which could not be reasonably allowed when the fund by which it is to be supported is small might be readily sanctioned should the wealth at the disposal of society

be in any considerable degree increased. This is an application of a general truth familiar to the latest phase of economic theory, namely, that our estimate of the importance of a service increases as we approach the possibility of its realization, while our estimate of the burden occasioned by the cost of a service decreases as the amount of wealth placed at our disposal increases. It is easier, for example, for the United States to assign \$380,000,000 to the support of the service of the Federal Government at the present time than it was to provide for the expenditure of \$3,000,000 in 1787—a result due not so much to the increase in population as to a rise in the productive capacity of the people. This thought, which is a familiar one to writers upon finance, is usually expressed by saying that the burden of a tax depends rather upon the ability of the citizen to pay than upon the amount paid, and that this in turn depends upon the average wealth of the citizen.

The claim that the aggregate of governmental expenditures is largely determined by industrial development finds support, also, in the general theory of social evolution. It is a fundamental law of social development that human wants are capable of indefinite expansion, but that their expansion will conform to the order of their relative importance. The conscious ability to satisfy a want which previously lay dormant gives to it a vitality that raises it from the rank of a simple desire to the rank of a vital principle capable of giving direction to social activity. As expressed by Bentham, "Desires extend themselves with the means of satisfaction; the horizon is enlarged in proportion as one advances, and each new want equally accompanied by its pleasure and its pain becomes a new principle of action." Now it is evident that, for the orderly development of society, new collective wants as well as new individual wants must emerge as development proceeds, from which it follows that industrial growth opens up to society ever-expanding possibilities, which, in part, will be reflected in a corresponding expansion of those functions which government alone can perform. A part, at least, of the increment of social income will be claimed for increased public expenditures.

From the point of view of social investment, also, does it appear that the expenditures of a State are dependent upon

the stage of industrial development attained. In the analysis of the foregoing chapter it was suggested that a profitable investment for a State is one which results in raising the grade of industry to a higher level of efficiency. This is a suggestion of considerable importance when one is in search of an explanation of increasing public expenditures among industrially progressive peoples. Should it be generally recognised that the increment of product resulting from the industrial development of the past, by means of which society finds itself in possession of a growing surplus, is in any degree traceable to the action of the State, it is but reasonable that men should willingly give support to a project calling for further investments along the same line. This is the way in which the business mind works in ordinary affairs, and it will undoubtedly follow the same line of reasoning when called upon to judge of public expenditures. The only thought against this conclusion is found in the claim that the necessity for government decreases as intelligence and a habit of voluntary association increase. The pertinency of this claim can only be determined by an investigation of the facts. But when it is recognised that growth in numbers, differentiation in the industrial process, and expansion of commerce and trade bring society face to face with new perplexities and new dangers at every step, it is not easy to see how the activities of a State can ever be less than they are at the present time. On the contrary, it seems reasonable to assume that with each increment in the social product the people will conceive it to be to their advantage to invest added sums in the machinery of government. From the point of view of investment, therefore, as well as from a consideration of the satisfaction to be secured from the activities of the State, may we conclude that the fiscal demands of government will increase along with, if not in proportion to, the general social income.

The above analysis is pertinent beyond that of strengthening the impression that the considerations which determine the aggregate of public expenditures root themselves in the industrial order. It suggests, also, the appropriate classification of states,[†] should one undertake a comparative investigation into public expenditures. If it be true that the amount of normal expenditure rests fundamentally upon the efficiency of

* For a classification of states from this point of view see § 16.

capital and labour within the country, the amount appropriated for the support of the State has no very definite meaning until referred to some particular stage in the order of material development, and through this to the rank or grade of the nation in question judged from the point of view of modern civilization. A cursory review of history shows that what for one nation is an indigenous growth is for another the result of imitation; what to one people springs easily and naturally out of their industrial conditions imposes upon another a conscious and possibly a severe strain. A comprehensive study of the growth of public expenditures, therefore, would call for a separation of those peoples with whom material development is the forerunner of fiscal expansion from those which, by the pressure of political competition, find it necessary, or think they find it necessary, to impose an extended fiscal system upon an inadequate industrial economy.

8. Public Expenditures and Political Conditions. The political conditions by which public expenditures are influenced pertain to external relations, or what may be termed the political environment of a people, and to internal relations or political organization. Our analysis will grant each of these relations separate consideration.

(1) *Expenditures and Political Environment.* It must be observed, in the second place, that the aggregate of public expenditures is closely related to the political environment of states. The most obvious illustration of this is found in the increase of military expenditures incurred by the leading nations of Europe; and, now that the spirit of Western rivalry has invaded the Orient, we may expect similar results to make their appearance in the budgets of China and Japan. The growth of expenditures in Europe in recent years, traceable to the necessity of living in constant preparation for war, has been very marked. The aggregate of military and naval expenditures for selected years since 1868 for England, France, Germany, Austria, Russia, and Italy is as follows: *

| Year. | Amount. |
|-----------|---------------|
| 1868..... | \$521,250,000 |
| 1873..... | 622,250,000 |
| 1882..... | 732,300,000 |
| 1888..... | 611,000,000 |
| 1895..... | 920,600,000 |

* First four amounts quoted from Bastable, p. 69.

No one would care to deny that these enormous payments for the support of army and navy are the results, possibly under existing conditions the inevitable result, of the spirit of nationality by which the foreign policy of modern nations is controlled. It would be incorrect, however, to say that the spirit of nationality is an adequate explanation of this expenditure; it is rather the contiguity of a warlike neighbour, powerful in resources, and equally strenuous in the assertion of its nationality, that imposes upon a people the necessity of a military budget. It is no part of finance to moralize on the nature of this expenditure. All that can be said is that the spirit of nationality is perhaps the most potent factor in the political life of modern peoples, and until it has spent its force, or until, through the development of international law, the necessity of appeal to the arbitrament of arms becomes less frequent, provision must be made in national budgets for military expenditures.

That the spirit of nationality in itself is not an adequate explanation of the growth of military expenditures is evidenced by the fact that it does not necessarily manifest itself in this form. Whenever a nation is so fortunate as to be separated by a natural barrier from neighbours who are foreigners by blood, enemies by virtue of their history, or irritants because they acknowledge a different social ideal, the fact is unmistakably reflected by the form of the ordinary budget. Many illustrations of this might be cited. Victoria, for example, out of a total annual expenditure of between \$40,000,000 and \$50,000,000 appropriates but \$2,000,000 or \$3,000,000 for defences. Her budget shows no separate chapter for army and for navy. The United States spends about \$42,000,000 on army and navy out of a total expenditure of \$380,000,000. In the former case the country is quite separate from any foreign power, in the latter, the contiguous countries are decidedly inferior in population, wealth, and national strength, and, what is perhaps of equal importance, the United States has no violent or deep-rooted historical prejudice, while her commercial and social interests are, in the main, common to those of neighbouring countries.

While it is undoubtedly true that contiguity of territory occupied by strong and self-assertive peoples is the most important of the surface facts in explaining the increase of mili-

tary expenditures among modern peoples, it by no means suggests a complete statement of what is meant by the phrase "political environment." The final thing in the analysis of national character is the conception of rights and duties, public as well as private, *inter-national* as well as *intra-national*, which a people entertains. This is equivalent to saying that the conception of law is the groundwork of social life. Now it is evident that government is limited in its application of law for the peaceable settlement of disputes to those questions respecting which there is a general consensus of opinion with regard to the rights and the duties that are involved. Beyond this point force of some sort must be employed, and provision for the exercise of force will be considered essential. This being the case, it is futile to urge disarmament, and the consequent extinction of the military budget, so long as there continues to be a conflict of legal ideas. The fundamental principles of the systems of jurisprudence, that phrase being used in its broad and comprehensive meaning, must be rendered harmonious before juridical procedure can supersede the employment of force. It is no accident that the first approach to a successful tribunal for the arbitration of international disputes should rest upon negotiations for a treaty between England and the United States, for these peoples practise the same system of jurisprudence. Their theory of rights, and the method by which they aim to enforce those rights, are the same. A standing international tribunal resting on agreement between England and Russia, however, or between the United States and China, is beyond the range of reasonable expectation at the present time; for it is only upon the basis of a common system of jurisprudence that a system of international law can be developed which shall render the preparation for war unnecessary. It thus appears that the controlling element in the political environment of nations by which military expenditures are determined is the similarity or dissimilarity of the systems of jurisprudence which the respective nations have adopted.

(2) *Expenditures and Political Organization.*—Public expenditures are open to another influence incident to the political conditions of nations besides the one bound up in the spirit of nationality. Their organization, so far as the relative importance of local and central administration is concerned, affects

not alone the distribution of expenditures between these two agencies of the State, but it affects the aggregate of expenditures as well. Confidence in this generalization must rest rather on *à priori* considerations than on statistical evidence, since there are no two nations whose political, industrial, and social conditions, exclusive of organization for local administration, are sufficiently alike to warrant statistical comparison. The considerations in support of this generalization, however, are simple and convincing.

Wherever local administration is well developed, especially if it proceed so far as to attain to the dignity of local self-government, a spirit favourable to collective service will be likely to show itself. Indeed, if the industrial growth take the form of an intense commercial or manufacturing life, the inevitable tendency toward congested population will force the necessity of cooperative action into the foreground; and whether this necessity be met by extending the direct services of the municipal government, or by granting liberal franchises to corporations (a policy which must in time necessitate adequate provision for holding them to public account), public expenditures will in either case be increased. The readiness with which expenditures for public undertakings will be incurred depends, other things being equal, upon the conviction among the people of their ability to manage their own affairs. It is sometimes remarked as a strange reversal of an accepted policy that Manchester in England, which was once the centre of the most intense form of practical *laissez-faire* should have adopted so readily the policy of municipal ownership of *quasi*-public works, but a cursory analysis of the situation shows this to have been natural in a country where local government has learned to be efficient, and where control over great commercial enterprises through corporations is a familiar idea to the people. What the manufacturers of Manchester objected to in their advocacy of free trade was that the protective policy of England did not enable them to control the conditions under which their industry was prosecuted. The restrictions imposed by government were an obstacle to their business success. The situation is the same at the present time with regard to private control of industries necessary to the industrial supremacy of the city of Manchester. The form of argument is changed, but the

spirit upon which it rests is the same, namely, a desire to control public policy so as to make it contribute to private advantage. If these considerations are sound, and there are others which look in the same direction, it follows that among those peoples whose political organization imposes heavy responsibilities upon local government, the aggregate of normal expenditure naturally tends to increase as the commercial life of the community becomes more and more intense.

There is, however, another phase of this question. The same spirit which tends to an increase of local expenditure—that is to say, the spirit of industrial independence on the part of the citizen—will act as a check upon the expansion of Federal or Imperial services, and consequently tends to curtail national expenditures. Wherever the spirit of local independence prevails one may always observe a quiet jealousy of central authority, which in many ways tends to limit the functions of the national government to such services as are beyond the possibility of doubt collective in character and common to all classes and sections of the country. Thus, although a people strong for local government choose to expand local expenditures, they naturally will endeavour to confine national expenditures within narrower limits than might otherwise be the case. The aggregate of expenditures, therefore, both grades of government being taken into the account, will be influenced in a decided manner by the relative strength of the two sentiments favouring nationalism or localism in political affairs. This argument would amount to nothing, however, so far as the influence of local government upon the aggregate of public expenditures is concerned, if the question in hand pertained simply to the division of a given range of public functions between national and local governments. Were this the case the amount spent by each government would depend upon the relative economy of the two centres of administration. But it is probable, in view of the way in which human nature works, that the check on national expenditure will be relatively less effective than the stimulus to local expenditure; and consequently we are warranted in the conclusion that the spirit of localism among democratic peoples tends to increase the aggregate of public expenditures. This, in one of its phases, is but another way of saying what von Hock asserts with such emphasis, that ease of raising revenue

is in direct proportion to the extent to which popular government is realized

The influence of the relative importance of central and local governments in the structure of the State may, then, be accepted as one of the permanent considerations which determine the aggregate of public expenditures, although its normal tendencies may at any particular time be set aside by some passing phase of political or industrial life. The western world at the present time, for example, is passing through a peculiar phase of industrial history, due to the development of cheap and rapid transit for goods and persons. This means a destruction of local markets and a consequent readjustment of the territorial distribution of industries. Moreover, a world's market is in process of creation, and the questions forced upon public attention by the fact that local trading centres are being crystallized into a world's market are, from the nature of the case, national in character, if, indeed, they are not international. The result of this is that, while society is adjusting itself to the new industrial conditions to which railways have introduced the business world, it is the national government rather than the local government to which people must look for the formulation of new legal conditions, and for protection against such evils as are bound up in this period of transition, no matter how strong may be the sentiment among the people at large against the concentration of political power. But these conditions are temporary. The readjustment will sooner or later be effected. Population will at no distant day settle itself in harmony with the new conditions. The new lands will be taken up, and manufacturing and commercial centres will be definitely and finally settled. Then, and not till then, the occasion for the constant appeal to central authority having passed away, will the spirit of local independence again assert itself and impose its check upon the expansion of Imperial functions. The student of finance must not be misled by the great increase in national expenditures since 1840, and he will not be misled if he keep clearly in mind the nature of the forces which determine political development, and recognise the exceptional character, so far as national expenditures are concerned, of the present industrial epoch.

It should also be remarked—if among political conditions

political corruption is to be counted—that the presence of political corruption, such as shows itself in so many of the municipal governments of the United States, will work against the normal influence of a strong sentiment in favour of local self-government. That is to say, it will tend to a curtailment of local functions, and ultimately of local expenditures. Many who recognise the evils of corporate control over *quasi*-public works, and who appreciate the importance of that wide range of social services which if rendered at all must be rendered through the agency of municipal government, are deterred from advocating an extension of municipal functions on account of the glaring evils of political corruption. It would be improper, however, to accept the prevalence of political corruption as a permanent factor. While it may properly influence a policy in the presence of given conditions, it must always enter into the theory of public expenditures as an exception to the rules laid down.

Our general conclusion, then, is as follows: (1) A strong sentiment in favour of local government, as indicated by the relative confidence in Federal or local centres of administration, will tend to reduce national expenditures below what they otherwise would be. (2) The same spirit, however, will tend to expand local expenditures, and, assuming the same line or class of services, it is likely that the aggregate of expenditures will permanently be greater when services are undertaken by local rather than by central control. (3) As modifying the above conclusion it should be added that the aggregate of expenditures may at any particular time be reduced below what it otherwise would be on account of the fact that local governments, however strong in theory, are in reality weak wherever political corruption prevails in local affairs.

9. Public Expenditures and Social Organization.—The aggregate of public expenditures depends, in the third place, upon the theory of social relations which a people has adopted, and the degree of strictness with which that theory is followed in practice. This theory may be looked for in the accepted philosophy of the respective rights and duties of government and individuals, or, what amounts to the same thing, in the attitude of mind which the public instinctively assumes when certain social or industrial problems are under consideration.

The problems of the class referred to are such as rely for their solution upon the extension, in some of its various forms, of the principle of cooperation, but a great deal depends, so far as public expenditures are concerned, upon the character of that cooperation. Is the collective activity demanded governmental or is it private? Is the cooperation desired to be secured by coercion or through voluntary association? One cannot emphasize too strongly the contrast between these two forms of social activity in their influence upon the ratio of public to private expenditures, or, as we are now discussing the subject, upon the aggregate of public expenditures.

It is exceedingly difficult in a few words to express the characteristic features of the social theories which, under various forms and with many and constant modifications, give colour to the social and political fabric of various states. These differences may, however, be suggested by observing that the one theory is a modification of the view of the State assumed by Roman law, and exemplified in a general way by most of the Continental peoples; while the other is a development of the Teutonic and Saxon ideas of personal liberty, and shows its most natural unfolding among peoples of English historical descent. The former makes the State the centre of all collective life, and defines the rights of individuals in terms of national importance; the latter places the individual at the centre of thought, and conceives of the State as one of several means to individual attainment and development. Under the influence of that philosophy which subordinates the individual to the State it is natural for those intrusted with the administration of government to regard all questions as properly adjusted when the interests of the State are conserved. Especially will this be true if to such a theory of society there be added the influence of the monarchical form of administration. It is logical, for example, that they who represent monarchical governments should accept the necessities of the State as the true measure of legitimate expenditures, without having very much regard to the concurrent needs of individuals; and in view of this trait of character, which leads men to unduly magnify whatever service they for the time being render, or whatever office they happen to occupy, it is not strange that the claim of government upon the social income should be strong for all those lines of service which

foster national pride and increase bureaucratic importance. It is easy, also, under such a social theory, for the spirit of paternalism to show itself in many of the items of a budget, and for the thought that the State is an industrial corporation as well as a political organization to swell the proportion of public expenditures.

The view of social relations which underlies English common law, on the other hand, works upon national expenditure in quite another manner, at least so far as those appropriations are concerned which minister to pride and foster bureaucracy, or which are related to the exercise of paternal functions. According to this theory a condition of liberty is conceived to be the heritage of the individual. The State is not regarded as an organism in the sense that it possesses soul, conscience, and sensibilities of its own; it is rather a form of association, and differs mainly from ordinary associations in the character of the service it has to perform, and in the fact that these services are of such a sort as require the State to be the depository of coercive power. Public concessions are judged from the point of view of the interest of the individual, and are approved or disapproved according as they bear upon his prospects. The result of this philosophy of social relations among peoples who practise self government is to insist that the government prove its case beyond the possibility of a doubt whenever it demands increased expenditures for approved services or the approval of expenditures for an unusual service. Greater reliance is placed upon voluntary association for the attainment of collective interests than upon coercive association. And this results inevitably in charging the cost of many lines of service to the income account of private corporations rather than to that of the State. In this manner, therefore, public expenditures are curtailed by virtue of individualistic philosophy applied to governmental affairs.

It must not be overlooked in this connection that, although the restrictive theory of governmental action may limit expenditures by curtailing the field of activity, it is likely, at least in the peculiar form in which it presents itself among commercial peoples, to induce lavish expenditures in those few cases in which industrial functions are imposed upon the State. Wherever, for example, a legislative body created by

popular vote undertakes, let us say, a system of public improvements at the expense of the general treasury, the project is sure to be undertaken upon a scale of too great magnitude. This is true because no member of the legislature, holding in mind the fact that he accounts to his constituency for his vote, will consent to any project which does not contribute directly to the prosperity of his constituents. It is a fact beyond question that investments of capital are unnecessarily lavish when made through the agency of popular legislative bodies; and it is on this account a wise conservatism for democratic peoples to hesitate before accepting the experience of governments highly centralized for administrative purposes as a proof that they could attain equally advantageous results in securing public improvements through governmental agency.

So far, therefore, as the bearing of the individualistic theory of social relations upon the aggregate of national expenditures* is concerned we may say that it is in the main opposed to such expenditures; but should public improvements, or any service, indeed, which results in localized investments of capital, be undertaken by a popular legislative body, a lavish expenditure of public funds must be counted upon as an inevitable result of such a decision.

10. Two Rules of Public Expenditure.—It may perhaps add something to the definiteness of these considerations if the rules of public expenditure, so far as they may be said to exist, formulated by the adherence of the two social theories mentioned, be passed in review

(1) *The English Conception of Public Expenditure.*—The rule, commonly regarded as adequate by those who hold the restrictive theory of government, is simple, so far as statement is concerned. No one has ever expressed this view more tersely than Sir Henry Parnell, who in 1830 published his remarkable tract *On Financial Reform*. The date of this

* A distinction is here made between national and local expenditures (cf. pp. 11-13), the line of distinction being that the territory controlled by a local government is so limited as to allow any scheme of public works to be comprehensive without endangering the success of the scheme. The political and industrial results, also, of public improvements differ according as they are undertaken by the national or by the local governments.

tract is significant. It appeared when the old individualism was at the height of its influence. The tract itself is important as having been influential in bringing about the financial reforms which place England in the fore rank of nations so far as taxation and regulations for international commerce are concerned. The following quotation is from the tract referred to:

“With respect to the principles on which retrenchment should be conducted it is of the greatest importance that they should be well considered, and, when decided upon, most severely adhered to. No person can have his mind in a perfectly fit state to form a judgment on any question of retrenchment without having acquired the habit, by previous study, of referring to what the uses and object of government are, and the grounds on which taxes are paid. The great error which is commonly committed is taking the utility of an expenditure as a sufficient justification of it; whereas, however useful it may be, if it cannot be shown to be absolutely necessary for securing some public object that could not be had by any other means as economic and as convenient, it is superfluous and ought to be discontinued. It is not an uncommon opinion among those persons who are in situations to have considerable influence in matters of finance that we ought first to secure all the revenue we can, and then regulate the expenditure according to it. Others allow themselves to be guided by their feelings and their passions, and, not having any fixed principles to go by, are continually favouring expense and resisting economy, when cases of apparent individual hardship come before them, not recollecting what those persons suffer who pay the taxes for providing for the effects of their mistaken compassion and unjustifiable liberality with the public money. If right principles were referred to they would suggest that taxation is the price we pay for government; and that every particle of expense that is incurred beyond what necessity absolutely requires for the preservation of social order and for protection against foreign attack is waste, and an unjust and oppressive imposition upon the public. Every minister and every member of Parliament who has the power to spend or to save the public money should do all in his power to prevent the wants of the State from depriving the people of the means of providing for their wants; and,

therefore, economy and frugality, which are virtues in a private station, from their vast influence upon national happiness in a public station, become the most pressing of duties" *

The three points in the above statement which may be accepted as formulating the theory of public expenditures advocated by Sir Henry Parnell are, first, that there should be no expenditure except "for securing some public object that could not be had by any other means"; second, that expense "incurred beyond what necessity absolutely requires for the preservation of social order and for protection against foreign attack is waste", and third, that the State should never demand sums which would result in "depriving the people of the means of providing for their wants." This is the doctrine of *laissez-faire* in its most extreme form, expressed in the language of finance. The third point above referred to has been expanded by other writers until it has come to be accepted by many English economists as the doctrine that taxes should always be levied upon what a man can save. Rogers, for example, says, in effect, that to tax what a man cannot save is robbery, which, if it means anything, means that the expenditure of the individual for support of government is not to be classed among necessary expenditures.

That these views are not in full accord with the attitude assumed in this treatise must be recognized from what has already been said respecting the nature of public expenditures. The financier is not at liberty to place the individual over against the State, or to ignore the fact that in some particulars public expenditure is different in character, and consequently subject to different rules, from private expenditure. To follow the rule submitted by Parnell would result in depriving the public of some of its most important governmental functions in the development of civilization, for it would cut off all expenditures which rely for their justification upon the ultimate rather than the immediate advantage to citizens. Nor can the student, whose aim should be to emancipate himself from the superstition of phrases, admit that any presumption lies against collective expenditures as such. All decisions must rest upon analysis, and not upon presumptions. It is not claimed as against Parnell that the State is justified in making use of the people's money when the people could

* *On Financial Reform*, by Sir Henry Parnell Bart., M.P. (1830), p. 118.

secure greater advantage by expending it through private agencies, but that the considerations which determine public and private expenditures in many classes of appropriations proceed along planes far removed from each other, and that a comparison between them is, to say the least, a very difficult matter. The rule, therefore, is of little advantage except for declamatory purposes.

(2) *The German Conception of Public Expenditures*—The theory of public expenditures entertained by many German writers, on the other hand, when pressed so far as to claim a presumption in favour of government whenever a new social function makes its appearance, is as erroneous as the one just considered. We may say with Stein that parsimony is not economy, and that "the saving proper for the statesman to consider is not that which always decides for the smallest amount, but that which knows how to measure the amount of expenditure to the worth of the object." ^b We may even go so far as to allow some truth to the simile of Geffcken, who says: "The administration of finances should be conducted according to the rule prescribed by nature, which everywhere abstracts moisture from the earth and the plants to give it back again in nourishing dews and rains." ^c We may, I say, depart so far as this from the old conception of the relation of government to industry, and still deny that the State has the first claim on the products of current industry. We cannot agree with Kaufmann when he implies that the fundamental principle underlying the taxing system of civilized states places justice to the citizen when compared with the needs of the State as a matter of secondary importance; ^d nor with Nasse when he asserts that "it is not justice to the individual, but the realization of the means destined to assure the onward march of the State and the accomplishment of its designs, which is the first object of taxation." ^e It is possible, of course, to interpret expressions like the above in such a way that due regard may be had to the interest of the indi-

* *Lehrbuch der Finanzwissenschaft*, by Lorenz von Stein, p. 137.

† Cf. Schönberg's *Handbuch der politischen Oekonomie*, Vol. III, p. 28. Article by Geffcken on "Grundsätze für die Staatsausgaben."

‡ Cf. Kaufmann, *Les Finances de la France*, p. 37. I have the French and not the German edition.

§ Quoted from Kaufmann.

vidual citizen, but in view of German national history and of German political philosophy it is doubtful if such an interpretation is possible to a German economist. Austrian financiers are not committed to so extreme an assertion of the importance of the State. A student imbued with the spirit of English jurisprudence, and who on this account must regard the State as an organ of society, cannot well understand how the claims of the State can thus be set over against the claims of the individual.

(3) *Conclusion*—The situation seems to be that the older English writers did not need a theory of expenditures because the theory of government which they held implied a fixed limit to governmental functions; while the earlier German economists* could not work out a satisfactory theory respecting the public use of money because their theory of government presented too strong a presumption in favour of the State. As is so frequently the case, the truth respecting public expenditures lies between these extremes, and can only be discovered by the concurrent study of public and of private functions. As already suggested, a theory of public expenditures must be a theory of the evolution of the collective wants of individuals, and its further development necessitates an analysis of the governmental functions, not alone as they now are, but as they have developed. In no other way can they be classified so as to enable the financier to determine the proportion of the social income properly assigned at any time to the support of government, or to measure the relative intensity of the various claims made upon the public treasury.

We are thus for a third time brought back to the thought that a classification of public functions is necessary to the unfolding of the theory of public expenditures, although in each case the suggestion was approached from a different point of view. The first occasion for this remark arose out of the comparison of public and private expenditures, when it was suggested that the theory of expenditures for the State was akin to the theory of consumption for the individual; and

* It is not possible to use the phrase "German Economists" as standing for a compact body of thought. The criticism in the text is addressed to what perhaps may be called the second generation of Historical Economists, whose political bent was given them by sympathy with the growth of German power.

that as the latter rests on the law of the development of human wants, so the former rests on the law of the development of governmental functions

The thought was a second time brought to notice by the statement that the theory of public expenditures is a theory of adjustments and apportionments—meaning by adjustment the assignment of a certain portion of the social income to expenditures through the agency of the State, and by apportionment the assignment of the amount thus set aside between the various lines of public service. It was stated that before a budget can be framed the various functions of the State for which the several chapters in the budget respectively stand must be classified in order to learn the relative importance of these functions for the life of the people

The necessity of the analysis and classification of public functions was for the third time brought into notice by the inadequacy of current rules respecting public expenditures. It was found that these rules were either too narrow to apply to the complicated conditions of modern society, or they were too comprehensive to allow of just discrimination respecting the relative claims of coercive and voluntary association. Some clear idea respecting the concurrent growth of public and private activity must be arrived at, and the manner in which each reacts upon the other must be duly appreciated, before specific appropriations for definite ends can come to have an explicit meaning. The claim of a definite appropriation is relative, and it is not until the function which it is intended to serve is fitted into the general scheme of social activities that the strength of this claim can be measured. In view, therefore, of the persistence with which the question of governmental functions asserts itself, one is justified in the conclusion that it holds the key to the theory of public expenditures.*

* It is perhaps unnecessary to repeat that the Science of Finance has no opinion respecting the question of the proper limit of public duties. The form of government is for it a given condition. It is equally true that the judgment of the financier respecting the wisdom of extending the sphere of the State in any particular direction, even though his views be expressed in the form of a discussion of appropriations, does not attain the dignity of a theory of expenditures which can properly find place in the Science of Finance.

CHAPTER III.

RELATION OF PUBLIC EXPENDITURES TO THE CLASSIFICATION OF GOVERNMENTAL FUNCTIONS.

THE PROTECTIVE FUNCTIONS OF GOVERNMENT.

- (1) Military Expenditures.
- (2) Police and Court Expenditures.
- (3) Expenditures for Protection against Social Disease.

THE COMMERCIAL FUNCTIONS OF GOVERNMENT.

- (1) Characterization of Commercial Functions.
- (2) Tendencies in Expenditures for Commercial Functions.

THE DEVELOPMENTAL FUNCTIONS OF GOVERNMENT.

- (1) Expenditures for Education.
- (2) Expenditures for Public Recreation.
- (3) Expenditures for maintaining Equitable Conditions for the Prosecution of Private Business
- (4) Expenditures for Public Investigation.
- (5) Expenditures for the Development of the Physical Basis of the State.

CONCLUSION.

THE important question which the theory of expenditure asks regarding the several lines of public service pertains to the influence of a developing civilization upon the grants demanded for the support of each service, and the discussion which follows will be with a view to some conclusion upon this point.

11. The Protective Functions of Government. — The public function which deserves first place in the classification of the services of the State, both by virtue of its importance and because it is historically the first to define itself with clearness, is the function of protection. The granting of protection was originally a very simple affair—so far, at least, as the idea is concerned, but with the passing of the centuries and the process of social evolution the protection which the State grants has taken upon itself several distinct

phases At present a classification of governmental functions must recognise three sorts of protection which citizens receive from the State. These are as follows:

First Protection against invasion from without

Second. Protection of life, property, reputation, etc., or, to speak comprehensively, of all those rights which pertain to man by nature, or are granted the citizen by common or by statutory law

Third. Protection against the spread of disease, either physical or social

(1) *Military Expenditures*.—Expenditures for protection against foreign invasion or encroachments from without may be properly designated as national military expenditures, and in early times this form of protection was the occasion of the larger portion of grants, whether of money, energy, or labour. Indeed, so vital is this function to the existence of society that other governmental functions were originally regarded as incidental to military service, and were on this account performed by the military leader With the advance of civilization, however, the relative amount of this expenditure, as well as the relative importance of the military chieftain, tends to decrease. In some cases this decrease is an absolute decrease in the amount assigned to the military service; but in a large number of cases, when compared with the claims of other services upon the expenditures of the nation or with the aggregate amount which the nation has to spend (that is to say, the social income), the effect of time is to lighten the social burden of the military service

It may seem difficult to sustain this claim in view of the expensive armies and navies which many of the modern nations maintain. But there are two observations which must be made before the military budgets of modern peoples can be accepted as proof that protection from foreign invasion is more burdensome now than formerly.

First. In some cases the increase in military expenditures of the Imperial Government is due to the consolidation under one control of what before existed in the form of local expenditures.

Second. Much of the expansion of military and naval budgets, of which so much is made in criticism of current politics, is due to the rapid development of naval and military

science, which gives rise to the necessity of improved army equipments and of larger and more perfectly constructed battle-ships; and this is an apparent rather than a real increase of the burden in question. Wars, if not less frequent than formerly, are of shorter duration, and are accompanied with a smaller percentage of casualties than in former times. In reality, therefore, progress in the art of offensive and defensive warlike equipments has commuted the burden of a war from a cost estimated in labour and life to a cost estimated in money, and is, consequently, in harmony with the civilizing tendencies of the last ten centuries, as reflected in the financial organization of modern as compared with feudal states.

A third observation might be made in this connection which, though true, is not peculiar to the military chapter of modern budgets, namely, that, when compared with the aggregate expenditure, or with the source of income from which all expenditures are drawn, the cost of army and navy appears to have decreased rather than increased in amount.

To return, then, to the question asked, there seems ground for concluding that the tendency of civilization is to decrease the burden which the necessity of protection against foreign invasion imposes upon the people. This should be, certainly, the normal tendency. One mark of growth in what we call civilization is the continuous appearance of new rights and the establishment of peaceful means for their adjustment. As international arbitration extends, armies and navies will be less frequently called into service, and as the moral force and individual character of the several nations becomes more marked, the support of armies for preservation of peace will become less necessary. If for a generation an opposite tendency should be observed, it is equivalent to saying that civilization has in this particular suffered a temporary check. Our general conclusion, then, is that an absolute as well as a relative decrease may be expected in military expenses as time goes on. Some facts upon this point are presented in the following chapter.

(2) *Police and Court Expenditures*—The second form in which the governmental function of granting protection makes its appearance brings into prominence the civic relation of citizens; that is to say, protection to life, property, and reputation. This function gives rise to expenditures for police

and for courts The function of personal protection, while not primitive, like that of protection which organic society demands for itself, is of very early appearance, and it is only necessary to contrast the state of society in which personal prowess or cunning was the only guarantee of individual safety, or of continued possession of property, with the present, when personal weakness or simplicity establishes a peculiar claim on government for protection, in order to appreciate how far this service of the State has developed. The expenditures occasioned by this service, however, have not grown in proportion to their importance, and this for two reasons.

First. Protection to person, property, and reputation consists chiefly in maintaining a condition of safety and decency in the community, and not in taking each individual consciously under the protection of government. There is no other phase of social activity where the economy of "manufacture in the gross" can be so effectively realized. The service in question is subject to what may be termed the law of diminishing expense

Second. Of more importance, however, is the fact that among the normal results of an advancing civilization is the development of old personal rights or the birth of new ones. Now this means more than the rise of some claim on the part of any particular class of men. it consists rather in the general recognition of the justice of the claim, and in the conviction among the people at large that it should be granted. It means that man's moral nature on its social side is brought under the influence of higher ideals; or, as it is sometimes expressed, it means the development of "social ethics." But, however characterized, it is clear that in proportion as these moral concepts work their way in the community the necessity for police enforcement of granted rights retires to the background. The reverse of this is equally true, and suggests a criticism on the budgets of some of our American cities. An increase of expenditures for police and for courts, at a rate more rapid than is justified by the growth or the shifting of population, or by the extension of duties imposed upon them, is proof of one of two things, it shows either that government is corruptly administered, or that the laws which the police and the courts are called upon to enforce are not regarded as just by the community. That is to say, it

shows that civilization is in a condition of arrested development. The normal tendency is for police and court expenses to rest more and more lightly on the community as the years go by.

(3) *Expenditures for Protection against Social Disease.*—According to the classification accepted, the protection of society from the spread of social disease is a governmental function of the same sort as protection of life and property. The agencies for rendering this service are of course quite various, and many of them, at least those which influence the budget in any decided way, are of comparatively recent origin. They do, however, at the present time make a very considerable showing in the modern budget. A good illustration of the form of service falling under this category is found in the changes in prison discipline and management which have followed recent investigations in the science of penology. It is no longer the thought that a criminal should be punished because punishment is in justice demanded, but that he should be restrained for the protection of society. So far as the criminal himself is concerned, the thought of reformation, or restoring him to society as a self-respecting and self-sustaining citizen, not only gives tone to prison management, but form to prison architecture. Crime is looked upon as a phase of social disease, and the treatment prescribed by the science of penology aims to cure that disease. This undoubtedly renders the prison service more expensive than the old method of incarceration, or the plan still followed in some parts of this country of working convicts in gangs upon public highways, or of hiring them out for such rough work as they can be made to do. That is to say, the first investment is more expensive and the expenditure per criminal is greater; but it is clear, if the criminal habit can be brought under control and the transmission of criminal tendencies checked by means of well-equipped prisons, reformatories, industrial schools for neglected youths, and the like, that the first cost should be regarded as a social investment the ultimate result of which will be to decrease the financial burden imposed upon society by the criminal class. The normal tendency therefore, of this chapter of expenditures is that they decrease in direct proportion as the reformatory policy succeeds. When it is remembered that a criminal reformed, or a man

saved from becoming permanently a member of the criminal class, means the addition of a man to the ranks of producers, the investment of funds for the attainment of such results finds a double justification.

Many other illustrations of this phase of the protective functions of the State naturally suggest themselves. Sanitary regulations, for example, which aim to ward from the community the introduction of disease, or to check the spread of disease when it has once gained a foothold, or to compel the observance of cleanly and healthful living, must be regarded as protective in their nature. Asylums for the insane, and in general for all the defective classes, are also protective in character. The fact that they are approved because of the sympathy which is felt for the unfortunate does not change this fact. Poor-law regulations, the administration of so-called public charities, old-age pensions (should public assistance go so far), and other like activities on the part of the State are the occasion of expenditures properly chargeable to the governmental function which we have termed protection. Pauperism is so closely allied to crime and vice on the one hand, and to weakness, deterioration, and contagion on the other, that it, also, can be treated as a disease to be extirpated if possible, or to be localized and controlled if extirpation is impossible. Attention might be called to immigration laws as yet another illustration of this phase of protection granted through the agency of the State. But sufficient has been said to make clear the character of this service.

It thus appears that society is exposed to a very considerable class of social diseases the control of which requires the employment of the coercive power of the State. The exercise of this control grants protection to the individual and guards society against weakness and decay. Will the expenditure for this phase of protection increase or decrease with the development of civilization? The answer given above with regard to prison administration applies in a general way to this entire class of expenditures. Assuming that no changes take place in the civic life or social structure by which the evils referred to are engendered, such as increased congestion of population, increased concentration of industrial power, the introduction of undesirable foreign elements, and the like, it may be said that the normal tendency of an advancing civilization

officials and conformity of conduct on the part of citizens. There is neither choice nor alternative. It is not possible in the matter of protection for the relation of buyer and seller to arise between the sovereign and the subject. Protection is not offered to be accepted or rejected as the citizen may choose; it is imposed upon him whether he cares for it or not. In no other way could the "condition of security" to which reference has been made be established or maintained.

In the matter of rendering service, on the other hand, the attitude of government is entirely different. It is not the life of the State but the interests of the citizen which are recognised as the ruling consideration. The character of these interests is of no importance, the pertinent point being that the services which minister to them do not from their nature, or on account of the relation they bear to the organic life of the State, necessarily demand public administration resting on coercive power rather than private management resting on commercial inducements. This second class of governmental activities may then be characterized as the commercial or semi-commercial activities of the State.

It is manifest that commercial activities may be undertaken with a view to the service rendered or for the purpose of filling the public purse. These aims are in no sense necessarily antagonistic, although the rule according to which the rate of payment is determined when the State renders a direct service will differ in the two cases. Those activities which are likely to be undertaken for the purpose of rendering a service rather than of securing a revenue are such as address themselves to some want universally felt, and are common to all citizens irrespective of locality or situation in life. The want also must be one in the supply of which economy may be secured on account of an extended and an assured market. The State may deem it wise to create a public monopoly in the case of such service, but such a procedure is not an essential feature of the case. In judging of the universality of any particular want the extent of the jurisdiction of the government in question must of course be taken into the account. A local government may very properly enter upon a more comprehensive line of activities than the national government, since the more restricted the territory over which a government has jurisdiction, the greater likelihood will there be of

community of interests among its citizens. With this suggestion the above statement may be accepted without reservation.

A large number of cases present themselves as illustrative of the functions undertaken by the State for the purpose of rendering services to citizens. The post-office, which in all civilized countries is carried on by government, is perhaps the most universal example, and may be accepted as a type of many other services of the same class. Slightly different in character is the function assumed by many governments of carrying passengers, freight, and packages, of transmitting telegraph messages, and of furnishing telephone service. It is assumed by many writers that these services are similar to that of the transmission of letters, but the fact that there is no harmony in the practice of modern states respecting these businesses suggests that they may not possess in all respects the same characteristics. While the further fact that such governments as do own and manage railways, telegraphs, and telephones regard them as a source of revenue, while letters are commonly carried at cost, renders this suggestion highly probable. All, however, when undertaken by the State, belong to the same general class of public functions.

Another illustration of public service rendered through the agency of the State is found in workingmen's savings-banks, insurance companies, and the like, although one is scarcely justified, owing to the limited sphere in which these agencies act, in saying that they represent an accepted governmental policy among self-governing people. The questionable feature of this class of services, and the reason why one may entertain some doubt as to their ability to hold a footing among governmental functions, is, that they pertain to the interest of a class, and a class interest is not easily recognised as a social interest. If, however, the business of banking and insurance is acknowledged to lie within the sphere of government, it must be classed with the commercial activities of the State.

Somewhat akin to these services, though entirely different in their financial character, are those acts of government supported in part or in whole by fees or assessments. The full discussion of these services must be postponed until the "Classification of Public Revenue" comes up for considera-

tion It is sufficient for the present to note that in the classification of governmental functions the recording of a mortgage, the granting of a passport, the laying of a sidewalk or the paving of a street, while of interest to society as a whole, do bring into prominence the important services which the government renders to a particular citizen. These services are not commercial in the sense that there can be any dispute as to the true policy of government respecting them, but they may be so regarded in the sense that the service is direct, and can be paid for, in part at least, by him who receives the benefit. It is on this account that they are assigned to the second general class of governmental functions

Many writers class among the commercial services of the State such undertakings as the administration of forests, of mines, of a system of irrigation, and the like, and provided the care of these agencies of public welfare is brought to a paying basis it is probable that this classification is the most natural as well as the most helpful. Mines are never undertaken except for profit, but in many cases the business is brought under public control where the accruing profit is not sufficiently large to warrant the undertaking did the government have no ulterior end in view. Wherever forests are of long standing, also, and especially in those countries where forest lands have not been alienated, their output is considered as a commercial product, and the forests themselves are regarded as a source of public revenue. On the other hand, where the lands have been alienated and the forest destroyed by the sale of standing timber, if the government be induced to undertake the development of the forestry system it will be on account of the general advantages accruing therefrom to society, and not for the purpose of making them the source of public revenue. The same is true of an extensive system of irrigation, the ultimate purpose of which must be to reclaim arid lands, or to render lands already under cultivation more productive. The true classification of such enterprises, therefore, depends in large measure upon the country for which the classification is made. In the United States forestry and irrigation must be regarded as ministering to the physical development of a State, and on that account would be included under the third class of governmental functions which hold in mind the physical and social development of a people. In

European countries, on the other hand, where the sale of timber, charcoal and ash products, and the rental of water privileges are made the occasion of specific payments from citizens, their administration must be regarded as service to be met by the payment of a price

(2) *Tendency of Expenditures for Commercial Functions*—The commercial or semi-commercial activities of a State, according to the foregoing analysis, include these three general categories of public functions—first, services sold to the citizen for a price, second, services but partially covered by the price, the price being called a fee or an assessment; and, third, services which justify public expenditure on account of the social interest involved, but which in the rendering give rise to a by-product that may be placed on the market at a price. The discussion now reverts to the original question, which asks what relation these industrial or semi-industrial activities of government hold to public expenditures, and for answering this question each of the above-named categories must be considered by itself

With regard to the purely commercial services, like the post-office, railways, insurance, and the like, the entrance of the government into the industrial field neither increases nor decreases the financial drain upon the social income. Provided the standard of living maintained by the people be the same, and consequently the market for a given service assured; provided the State and private agencies are equally efficient in the rendering of the service; and provided the same rule be adopted for determining the price of the service—the social expenditure will be unaffected, no matter how far the State proceeds with industrial functions. The question does not, therefore, pertain to the theory of public expenditures, as such. It is fundamentally a question as to the agency through which a definite portion of the social income will be expended. The above conclusion must be allowed, even though the State decide to make a particular service the source of a general income by charging a price in excess of the cost, inasmuch as all that is secured in this manner will lessen the amount to be taken from the income of citizens through taxes. The social income by which all social functions are supported must include the earnings of public as well as of private industries.

There is one way in which the State will be likely to increase the current payments for those services which it undertakes beyond what they would be if the service were consigned to private control, and that is by giving greater attention to social and national development than to business considerations. One of the chief arguments urged by German writers in support of government railways is that the poor districts as well as the rich districts will in this manner be provided with transportation facilities. Such a policy would naturally lead to a greater expenditure for the service of transportation than if rendered by private corporations, and, in so far as this be the case, the expenditure would tend to fall under the general head of investments of capital for the purpose of national development. It is likely, also, that the rule for determining the price of certain classes of services would be determined by social rather than commercial considerations, as is decidedly the case in connection with postal rates, so that a rich locality might be called upon to pay more than its proportion of the aggregate cost of the service, but the aggregate cost to the community as a whole would not on this account be in any way affected, except so far as traceable to a more extensive rendering of the service in question than would otherwise be the case.

While it is doubtless true that the burden on the social income is affected in no very marked degree by the assumption of industrial functions on the part of the State, the aggregate expenditures of government are of course greatly increased. This is shown in the local and national budgets of most modern peoples, especially in England and on the Continent. Whether or not the extension of government industries is "in the line of advancing civilization" is a question about which history makes no absolute reply. The facts are variously interpreted. By some the extension of industrial functions under the direction of government is termed socialistic, and socialism is regarded as the inevitable and desirable outcome of democracy. There are others who, while agreeing to characterize this tendency as socialistic, see in it a perversion of democratic concepts, and claim that the permanent tendency is toward the extension of private enterprise under voluntary association.

There is still another class of thinkers who do not consider

it worth while to define socialism in the language of governmental functions, but who assert that under present conditions certain industries can be managed by government with better general results than by private enterprise, and who assert that this is ample justification for the assumption by government of industrial functions. These thinkers do not regard any theory of social organization as important. The practice of the English-speaking people in the past seems to them eminently sensible, that is to say, to permit social principles to emerge from discussion of particular questions rather than to undertake to decide specific cases on the line of *à priori* principles. If Manchester desires to own street railways, let Manchester try the experiment. If the experiment is successful, other cities will probably follow its example; if not, other cities will be saved a false step.

In such a condition of uncertainty respecting current opinion as to the interpretation of the assumption by the government of industrial functions, one cannot state with any degree of confidence what the future of public expenditures of this class is likely to be. They have increased enormously during the past forty years, nor is there any evidence that the tendency is exhausting itself. It seems probable, when one regards the social evils wrought by corporations in certain industries of collective interests, that local governments at least will expand rather than contract the sphere of government administration. But whether this be true or not, the important fact for the student of finance to hold in mind is that public industries are a source of income as well as of expenditure, and that the amount of industrial expenditure is a matter of fiscal indifference. The entire question turns upon the choice of the means of satisfying certain common collective wants, and this is a question of the relative efficiency of two methods of investing a given amount of capital, and not of the relative amount of capital invested.

It is possible to answer a little more definitely with regard to the semi-commercial services paid for in part by fees and assessments and in part by general taxes. These expenditures will undoubtedly tend to increase with the increased complexity and intensity of modern life. This is true because the demand upon government for a certified evidence of its presence, its approval, its guarantee of right

or privilege, its attestation, its voucher, its assistance in legal processes, and the like, for which fees are paid, must increase. It may be that the collective or social interest will become so important that the attempt to assign any portion of the cost of these services to particular citizens in the form of a fee will be abandoned, but the presence of government in the varied relations of life can never be less than at present, except indeed society enter upon a period of decay.

The above conclusion is equally true of assessments. Payments for bearing in part or in whole the improvements necessary to an agreeable and healthful municipal life, such as sewers, waterworks, sidewalks, paving, and the like, are certain to increase as long as the industrial forces continue to increase urban population. In a sense assessments do not constitute a payment for public services at all, but rather an investment of private capital, since the result of the expenditure is to raise the value of property; and the only justification of interference by government in the matter is the imperative necessity of uniform action on the part of the holders of property within the municipality. For the present purpose, however, this distinction is of no great importance. So long as cities continue to grow, payments in the form of assessments will continue to increase.

It is not necessary to pass judgment in this connection upon payments incident to forestry, irrigation, the administration of mines, and the like, since the undertaking of such services in this country would under present conditions be regarded as general rather than direct services.

13. The Developmental Functions of the Government. - Those lines of public activity which, according to the analysis here adopted, comprise the third and final class of governmental functions, are such as spring from a desire on the part of society to attain higher forms of social life. The aspiration of individuals, although necessary to this end, is not adequate for its realization; it is equally important that society in its organized capacity should enter upon a series of orderly changes under the direction of a definite programme of social development. The theory upon which such a programme rests is supplied by modern science and modern philosophy, and assumes that it is possible for the State to de-

termine, in a large degree, the conditions under which men live, and in this manner to make intelligent selection of the influences by which they are surrounded. Thus the structure of society and, in a measure, the character of the citizen lie within the choice of those who formulate and execute laws. To make use of the language of modern philosophy, society is a conscious organism capable of determining its own environment, and consequently of directing its own growth. It is this thought which warrants the acceptance of the phrase *developmental functions of government* as giving adequate expression to that comprehensive line of public duties by which the conditions of life are determined, so far as they are dependent upon law and administration.

It may be suggested by the critic that all functions of government minister to social and individual development, and on this account that it is improper to set aside any definite group of functions as developmental in character. In a sense this is true. The protection of life and property, for example, affords conditions which invite healthful activity on the part of citizens; but the protective functions of the State are addressed primarily to the evils of society, and are efficient in proportion as they repress the perverted inclination of individuals or destroy the unpropitious conditions in society. The developmental functions, on the other hand, recognise the good in human nature and the useful in society, and are successful in proportion as they lead to the growth of what is good and the fruitage of what is useful. Both classes of public duties are necessary to social development, but the one being repressive in its nature, while the other undertakes a process of cultivation, there seems to be a clear difference between them—a difference which is most significant when considered in its relation to the natural law of public expenditures.

It will be of assistance in tracing the influence of the developmental functions of government upon public expenditures to analyze a little more closely the forms of activity which they embrace. Of these there are at least five sufficiently distinct to warrant separate consideration. They are as follows:

1. The function of public education
2. The function of providing public recreation.

3 The function of creating and maintaining those legal and administrative conditions in which private business enterprises will be conducted in a just and equitable manner.

4 The function of public investigation, by which society may come to a knowledge of itself, and furnish to the administrator and to the public at large such information as is necessary to guarantee the normal working of the principles of popular government and of voluntary association

5 The function of developing the physical basis of the State in so far as that cannot be judiciously accomplished by private enterprise.

(1) *Expenditures for Education* —It is not necessary to consider at length the educational functions of the State in order to set forth the familiar arguments by which all civilized nations have been led to make more or less ample provision for public instruction. It is sufficient for our present purpose to observe that the institution of public instruction is one of the many results of the general recognition of solidarity in social interests. It is the natural unfolding of the theory of social relations which asserts that the cultivation of the individual is of greater relative importance to society than to the individual himself. This truth may be illustrated from any branch or phase of education whatever, whether it be a common-school education, industrial or trade education, professional or technical education, art education, or what is called the higher general education. In every instance an analysis of the social results shows that the benefit of an education to the individual is proportionally less than its advantage to the other members of the community. The physician, for example, would secure relatively as large an income and enjoy as marked social distinction on the basis of a less perfect as of a more perfect preparation for his profession, provided only he has acquired, according to his talent, the average or customary education of his class. Except for the scientific interest he may feel in the discovery of new truths, he has nothing to gain by raising the general level of professional practice. They who take the physic, and not they who give it, are in a position to appreciate most keenly the importance of high attainments in the medical profession. The line of reasoning involved in this illustration applies equally well to any phase of education, and makes clear the truth that the effective demand for profes-

sional or personal excellence is a social and not an individual demand; and it is on this account that the true significance of an educational system, its relation to the progress of civilization, and the duty of government respecting it cannot be appreciated except it be considered from a social or collective point of view

The fact that education is a matter of public concern is, however, scarcely adequate to justify its support at public expense. Why should not he who receives instruction pay its cost, or, if such a plan for any reason be regarded as untenable, why should not exclusive reliance be placed on private endowment? These questions must be answered before the natural law of public expenditure for educational purposes can be discovered

The reason why education cannot be consigned to private enterprise is that the commercial expression of the social demand for individual excellence, that is to say, the willingness to pay for expert services, is not adequate to guarantee the needed supply. This is true, because it requires either experience or imagination to appreciate the worth of trained service, and until universally appreciated the pecuniary inducements accruing will not warrant the investment of time and money in its attainment on the part of him who practises a profession. Now the public at large cannot have experience with a quality or grade of attainment until it becomes the common possession of the class or profession that makes use of it, and the imagination which calls it into existence is not spontaneous, but imitative, so far as the mass of the population is concerned. It is essential, therefore, if orderly progress is to be secured in the arts and the sciences, through rendering universal the exceptional attainments of individuals, that the State, availing itself of the judgment of experts, should have a directing voice in all matters pertaining to education.

That the State should provide the means of education as well as prescribe the grade of attainments for those who purpose to render social service is equally conclusive, although the reasons which may be assigned for such a conclusion are not so simple of statement. It is a pertinent fact, though not final in the argument, that all great education systems have been developed under the influence of a social necessity ex-

pressed with more or less clearness through the medium of the State. Confining our attention, however, to those peoples who aim to realize democratic ideals, it is essential for the modern State to support public instruction, because there is no other way to guard against the fading of its own ideals through the rise of an aristocracy of learning. It is natural that institutions that look to the wealthy for further endowment should be influenced in their administration by the interests of the wealthy class; it is natural, also, that the charge for instruction in such institutions should conform somewhat to the cost of rendering it. Both of these results follow as a matter of course from the introduction of commercial principles into education, and it requires no great insight to perceive that the final result of exclusive reliance upon private benefactions for any phase or grade of education will be that the instruction provided will not only reflect the interests of a class, but will be confined to a class. This is no place to discuss the far-reaching consequences of such tendencies. To say that they are not in harmony with the ideal of democratic civilization is to express but mildly a great truth. A State which aims to perpetuate democracy cannot decline to make ample provision at public expense for all phases and forms of education. In no other way can a system of public instruction, which is by far the most potent agency in shaping civilization, be brought to the support of democracy.

It must be remembered that the natural law of public expenditures, which it is the purpose of this analysis to discover, assumes the permanency of popular government. It assumes also an efficient democratic sentiment which stands not alone for equality of opportunity, but for a high plane of individual attainment and a high grade of social development. This being the case, education will inevitably demand a continually increasing share of social expenditures, and in proportion as the antagonism between private endowment for education and the ideal of modern civilization is apprehended will the source of this expenditure be the contribution of the people to the treasury of the State, rather than the gifts of the fortuitous wealthy. A continual increase in the educational budget, therefore, must be expected as a natural result of social development, and may be accepted as a normal expression of a healthful society.

(2) *Expenditures for Public Recreation*—The line of reasoning presented above applies with slight modification to public recreation. What is commonly termed recreation is in part educational—a remark which applies to music, the drama, art and art museums, books and public libraries; in part it is designed to give rest and refreshment—as is true of public parks and public gardens; in part it is designed to bring out the nobility of life by enabling the individual to associate with what is dignified and satisfying—as, for example, beautiful streets and worthy buildings. The suggestions to which a consideration of public recreation gives rise have indeed a broad outlook. Their point of view is that of the collective interests of society; their ideal, the purpose to make life a thing of worth. One is not, of course, at liberty in a practical treatise to rest important conclusions upon a forecast of the future; but the opinion may perhaps be ventured that government is coming more and more under the influence of the consciousness of collective interests; and that as one result of such a tendency, an increase in the expenditures of the State for public recreation (that word being used in its comprehensive sense) may confidently be expected for years to come. Especially is this likely to be observed in the budgets of municipal governments.

(3) *Expenditures for maintaining Equitable Conditions for the Prosecution of Private Business*—Among the concessions made by economic theory during the last thirty years is the recognition of the necessity of prescribing the conditions under which contracts may be concluded and voluntary association established. While industries remained small, before factories were established, and before a world's market had been created by the use of steam in transportation, the arguments in favour of unrestricted and unregulated competition were fairly conclusive, but since the Industrial Revolution has modified class relations and shifted the centre of industrial power, the evils that follow the attempt to make an absolute separation between state and industry are so manifest as to compel the recognition of industrial functions on the part of government, in addition to the function of enforcing contracts and protecting property. The conservative expression of the sentiment thus engendered, which acknowledges the inadequacy of the theory of non-interference, is

found in a demand for the extension of the sovereign power of the State in two directions. first, in determining the plane of competition where competition may safely be allowed; and, second, by substituting the control of *quasi-judicial* tribunals for the control of commercial forces in those industries in which competition is observed to work badly. The former leads to a long line of legislative acts technically known as "Factory Acts," the latter leads to the establishment of public "Commissions."

It is the purpose of both of these agencies of the State to realize in industry the ethical ideals approved by the social conscience. Factory legislation depends for its efficiency on the exercise of police supervision. The service of mining inspectors or factory inspectors is, for example, in its nature a police service, and the general conclusion arrived at respecting the natural law of expenditures for protective governmental functions applies in the main to this class of public duties; that is to say, the expense of the service tends to decrease in proportion as the service is effectively rendered. There is, however, in the case of those functions of government which aim to determine the plane of competition this peculiarity: the ideal of society as to what constitutes justice tends ever to a more refined conception of industrial ethics, and on this account the successful administration of a law which has fixed a certain plan of industrial activity prepares the way for fresh legislation by which the quality of business conduct is approximated yet more closely to the ideal of justice. This means that expenditures for the administration of factory laws, provided they are successfully administered, will make clear the necessity for yet further legislation of the same sort, and in consequence become the occasion of constantly increasing expenditures. Such is the law of expenditure for those governmental functions which aim to realize in business life a plane of business conduct approved by the moral sense of the community.

The same conclusion follows from a consideration of the conditions that render commissions a necessary part of the machinery of those modern states which hesitate to own and manage such industries as from their nature are superior to the satisfactory working of competition. To avoid misunderstanding, it may be said by way of illustration, that the busi-

ness of inland transportation is typical of the class of industries referred to. Many are the evils, political, social, and industrial, which result from consigning this industry to the control of competition, and it is now universally recognised that railways must either be owned or controlled by the government. It would be out of place to consider here the arguments for public control rather than government ownership, it may, however, be remarked that if the former policy be approved by public opinion, as is the case in the United States at the present time, it follows that commissions must be established with adequate power and ample means.

But the necessity of commissions does not stop with the railway industry. Modern industrial life tends continually towards the crystallization of larger capitals in many lines of industry. The monopoly problem presents itself under many forms, and, with the continued differentiation which marks the business life of the day, it may be expected that new phases of that problem will continually present themselves. Now what is known as the "commission idea," according to which the government claims the right of representation on the board of management of a business enterprise for the purpose of guarding the interests of the public in its administration, must be granted a development *pari passu* with the development of the dangers to which those interests are exposed on account of the growth of large industries; and from this it follows that as long as industrial development tends to the concentration of capital, so long will the government be obliged to extend this domain of its activity for the purpose of guarding society against the evils sure to arise from the crystallization of industrial power, and of directing the power thus generated to the service of the State. This means that the expenditure of government for the control of monopolies must continue to increase so long as industrial society continues to develop along the lines it has followed during the last half-century.

The normal law of public expenditure, therefore, for the support of factory legislation, or public commissions, these phrases being accepted as typical of the class of expenditures in question, is that such expenditures will continue to increase, until industrial development has run its course, or until by

some great upheaval in society the character of government itself shall have been changed

(4) *Expenditures for Public Investigation.*—Many reasons might be assigned why public investigation is to be classed among the developmental functions of government. Not only is a knowledge of conditions and tendencies, which can alone be obtained through careful statistical research, necessary to a rational programme of social progress, but at the present juncture in social evolution an extended use of statistical inquiry and of the right of investigation on the part of administrative boards is essential to the realization of either of the two theories of government which present themselves for approval. Reference is here made to the theory of collective management of monopolistic industries on the one hand, and to the theory of governmental control over monopolistic industries on the other. The former is sometimes termed socialism; the latter, new individualism. It is not intended to consider the function of public investigation or of statistical inquiry from the point of view of State socialism farther than to remark, that any political adjustment which relies upon the arbitrary adjudication of State officials, rather than upon the spontaneous activity of individuals, for attaining social progress must bring into prominence a universal system of industrial accounts. One of the chief activities of a socialistic government would be to keep the books of the social industries. In so far as socialism is realized, therefore, an increased expenditure for the collection, the classification, and the compilation of facts must be expected.

The function of public investigation is not less important, though it may perhaps be applied in fewer lines of industry, where it is the purpose to solve the modern monopoly and labor problems in harmony with the theory of personal liberty as developed by the English speaking peoples. A word of explanation may be necessary to make this clear. According to English political philosophy an extreme expression of the doctrine of industrial liberty would restrict the functions of the State to the protection of life and property and to the enforcement of contracts, reliance being placed upon commercial forces or, as it is termed, the principle of competition to guarantee reasonable prices and equitable treatment to the

public The evolution of great industries, however, has shown that this theory presents but one side of a complete programme of social development There are some industries which are not subject to the satisfactory control of competition, and upon these the State must impose judicial or administrative restraints Whether these restraints should be judicial or administrative depends upon the nature of the industry; but in either case a full and complete knowledge of the facts pertaining to the business, and to the conditions under which the business is carried on, are essential for effective control It may be expected, therefore, as industrial society becomes more and more complex through the differentiation of industrial functions, that new questions will arise for adjudication and new bureaus of administration established, and it needs no argument to prove that an extension of public investigation will be a necessary accompaniment of this tendency.

For the purpose of making this point clear, reference may be made to the reliance of the Interstate Commerce Commission upon statistical investigation. The chief purpose of the law which created this Commission was to abolish the practice of discrimination. With this end in view a special tribunal was created, clothed with the power to investigate cases of discrimination and to secure from the courts summary procedure for the purpose of causing such discrimination to cease. Now it would be idle to suppose that five commissioners could exercise police surveillance over six or seven hundred railway corporations having in their employ upwards of nine hundred thousand men Reliance must be placed for the execution of the law upon the willingness of shippers against whom the railways have discriminated to bring their complaints to the Commission But this they will not do except there be some certainty of quick redress Shippers who suffer the evils of high rates while their competitors enjoy low rates will prefer to carry their complaint to the managers of the railways and extort from them like privileges for themselves. This suggestion leads to the following conclusion: that, as a condition requisite to the execution of the Interstate Commerce Act, it is essential that the accounting system of the railways should be organized as a unit and placed under the control of the Commission, and that the Commission

should in this manner have access at first hand to all the facts in any case which may possibly arise. This means that the success of the Interstate Commerce Commission relies very largely upon the development of its statistical service, since in no other way can the act become self-executory, that is to say, rest for its guarantee of execution upon the interests of aggrieved parties. The reasoning employed in the above illustration is equally applicable to all cases where it is sought to guard the public against the evils of monopolies, great industries, trusts, and the like, through judicial or administrative control.

From another point of view, also, does the function of public investigation present itself as of continually increasing importance. The theory of society which relies upon the spontaneous activity of individuals for progress, except in those industries which are by nature monopolistic, appeals to the principle of competition for securing commercial equity and justice. The chief obstacle to the realization of this theory is found in the uncertainty which surrounds business transactions. This being the case, no government which aims to apply the theory of *laissez-faire* to non-monopolistic industries can evade the necessity of making large expenditures for the purpose of collecting, compiling, and publishing those commercial facts which are essential to safe business calculations. As publicity is essential to the spontaneous execution of those laws which aim to control monopolistic industries, so also is publicity necessary to provide the conditions in which the competitive theory may work satisfactorily for industries that do not tend toward monopolistic organization. From whatever point of view, then, one considers the future, whether that of socialism, of governmental control over monopolies, or competitive control over non-monopolistic industries, the student arrives at the same conclusion with regard to the law of public expenditures. Governments must continually increase the amount of money placed at the disposal of their statistical service. The function of public investigation is one which must expand with the development of society. The principle of publicity is a most important principle for the realization of voluntary association. An increase in the expenditures for statistical investigation is not only a result of social development, but in its turn comes to be a cause of

further development; and the opinion may be ventured that no class of expenditure, excepting only that incurred for public education, is of more vital importance to the interests of the State.

(5) *Expenditures for the Development of the Physical Basis of the State*—The last of the developmental functions of government, according to the classification here adopted, pertains to the development of the fiscal conditions of the State. There is here included all those lines of activity which call for an investment of public capital and which are commonly included under the general phrase "public works." Adopting the conservative view, such investigation would included the appropriation of public moneys for works of undoubted advantage to society at large, but to which private capital will not be attracted on account of the uncertainty of profit or the long time covered by the investment before any profit may be realized. Forestry, irrigation, the dredging of rivers, and building of canals, docks, lighthouses, and the like, are illustrations of the investments in question. It is only necessary to mention what is embraced in this class of governmental functions to warrant the conclusion that the expenditures which they entail will tend to increase with the growth of society. Density of population, increase of wealth, and advance in the mechanical arts will induce each succeeding generation to contribute more largely to that class of investment which gives a return in the form of public utility, rather than in the form of private income. Without further analysis, therefore, it may be concluded that the function of developing the fiscal basis of the State, in so far as that cannot be accomplished by private enterprise, will, like the other developmental functions of government, tend to increase rather than decrease its demands upon the public treasury.

14. **Conclusion.**—It is possible to summarize the results of the foregoing analysis and present them as a general conclusion upon the subject, and in doing so the division of the functions of government into Protective, Commercial, and Developmental will be observed.

The protective functions of the State tend to decrease in their claims upon the social income. This is true because the protective functions of government minister to social development by repressing the unpropitious forces in society, thus

giving the propitious forces an opportunity to operate. They work in the same direction as the developmental functions of the State, but by a reverse process. The success of the repressive activities of the State tends to curtail the necessity of their exercise, so that in proportion as ample expenditure for the protective functions is granted where there is need of their exercise, will society subsequently be relieved from the necessity of appropriations for this service. The practical conclusion from such a law of expenditure is, that a government cannot afford to hesitate respecting this service. As protection is the primitive function of government, so it is relatively more important than any of the duties of later development. The increase in appropriations for other functions may, and in a healthfully progressive state will, arise in part from the savings which accrue on account of the success attending the performance of the protective functions.

In order, however, to properly apprehend this part of the law of expenditure for progressive peoples, it is necessary to make three observations respecting it:

(a) The law applies more strictly to the exercise of "police power" than to the exercise of the military power, for the reason that the former is exercised under the jurisdiction of a single system of jurisprudence, while the latter implies controversy between several nations which may or may not conform in the order of their thinking to a common ideal of justice and liberty. In the one case, controversy invites the development of social ethics through a refinement of personal rights; in the other case, nothing is decided as the result of the controversy except the relative strength of armies and navies. For this reason, while it is possible to speak with some degree of assurance respecting the normal trend of police and court expenditures, the financier is not at liberty to speak with any great degree of certainty respecting the trend of military expenditures.

(b) The second observation pertains to the statistics of expenditure rather than to the law of expenditure. In considering the appropriations for protective service from year to year, it must be recognised that a part of the expenditures charged to current expenses in the ordinary accounts of nations is in reality an investment of capital. It is as true of public as of private administration that expenses may be cur-

tailed by the employment of costly machinery. This remark applies to all the protective functions of the State.

(c) It must also be held in mind that the protective functions of government so modify the nature of the service which they render from year to year that, should the services of policemen to-day be compared with those of fifty years ago, marked change in the nature of those duties would be observed. It would not of course be correct to say that the law of expenditure for police service must be confined to services of exactly the same sort, but at the same time it must be admitted that social development has occasioned an expansion of the functions imposed upon the police power, and that the statistics of expenditure for this service must be interpreted in the light of these constantly expanding functions. With these observations, all of which are gleaned from the preceding analysis, no misconception can arise from the statement that public expenditures for protective functions of the State tend to decrease as society develops.

Our conclusion respecting the commercial expenditures of the State is that they have nothing to do with the theory of public expenditures. So far, however, as they are general in character it is probable that they will increase rather than decrease with social development.

The law of expenditures for the developmental functions of the State is that they tend constantly to increase with an increase of social intelligence and with the progress of social differentiation. Their peculiarity stands forth most clearly when placed in comparison with the expenditures demanded by the exercise of the protective functions. Success in the administration of the protective service tends to decrease the amount demanded for that service in subsequent years; success in administration of a developmental service, on the other hand, results in an increased demand for services of the same class. The only observation which it is necessary to make lest the student misapprehend this generalization is that the "police power" is used by modern peoples as the agency through which many of the developmental functions of the State are carried out. The police service is broader than police protection; and much of the expenditure incurred for maintaining what is technically known as the protective agen-

cies should be charged in strict accounting to the developmental functions of government.

The general law of public expenditure for progressive peoples, then, is as follows. Public expenditures tend constantly to increase, but this tendency does not apply in like manner to all governmental functions. Expenditures for protection exhibit a tendency to decrease in proportion as the protective service of the State succeeds; expenditures for developmental functions tend constantly to increase. This being the case, the test of successful fiscal administration, so far as expenditures are concerned, is not found in the aggregate amount placed at the disposal of government (although this, as we have seen, is also subject to a social law), but in the relative amounts which from time to time are assigned to the several chapters of the budget. As a rule, a possible exception being made for military expenditures, the older the protective function the less will be the percentage of aggregate expenditure assigned to it, while the newer the developmental function the greater will be the relative demand which it makes for the funds to be placed at its disposal.

CHAPTER IV.

SOME FACTS RESPECTING PUBLIC EXPENDITURES.

CHARACTER OF PUBLIC EXPENDITURES PRIOR TO THE NINETEENTH CENTURY.

PUBLIC EXPENDITURES SINCE 1830.

PUBLIC EXPENDITURES AND WEALTH.

GROWTH OF LOCAL EXPENDITURES.

ANALYSIS OF AGGREGATE PUBLIC EXPENDITURES IN THE UNITED STATES.

THE theory of public expenditures submitted in the preceding chapter rests primarily for its sanction upon an analysis of those motives for action and conditions for judgment that present themselves to the common observation of all. If these motives and conditions have been properly understood, and their relative importance properly apprehended, the conclusions of the analysis cannot have gone far astray. Partly for the sake of testing these conclusions by such statistical data as it is possible to discover, and partly for the purpose of presenting the theory in a more concrete form, but more especially with a view of discovering to what extent increased expenditure means an increase of burden, and in what manner the weight of the public service shifts itself from time to time, it is the design of the present chapter to submit a few facts pertaining to the inquiry in hand. Certain questions, also, capable of throwing added light upon the problem of public expenditure may suggest themselves as the investigation proceeds.

15. Character of Public Expenditure Prior to the Nineteenth Century.—At the close of the Napoleonic wars it was the general assumption on the part of statesmen that public expenditures had reached the limit of their expansion, and it was expected that the payment of the principal and the reduction of the interest of public debts would permit a reduction

of ordinary expenditures "Gentlemen," exclaimed Villèle, the French Minister of Finance, when the French budget reached for the first time a million francs—"gentlemen, salute these figures, you will never have an opportunity to contemplate them again" * Although this sanguine view of statesmen and publicists has not been realized, it is easy to understand the state of mind by which it was indulged. In the first place, it must be remembered that military expenditures, including "marine and colonial," had for three hundred years been among the chief items in the annual budgets. These three centuries had witnessed the development of nationality through the centralization of power in the hands of a personal monarch. The feudal array had given place to the standing army, and the maintenance of paid retainers had become a necessity on account of dangers to the authority of the prince from within, and to the interests of the nation from without. The period was marked by internal revolts and commercial wars. "Fully one-half of the income of European states," said Justi in 1771, "is used by the military, in states with threatening neighbours two-thirds; in Prussia three-fourths" † The military burden of Prussia during the period under consideration seems to have been up to the margin of the ability of the people to bear. Placing in comparison the two dates 1713 and 1806, it appears that the increase in population had been in the ratio of 1 to 6.69; the increase in the army meantime had been in the ratio of 1 to 6.58, and the increase in the expenditures for the army in the ratio of 1 to 6.50. So uniform an expansion of these three factors suggests, if it does not prove, that the army took from the people all the people had to surrender. The budgets of other European states reflect the same general fact, although in France the lavish expenditures incurred for the court display were added to the burden of military expenditures. Speaking very broadly, this régime of monarchical rule was brought to a close during the first decade of this century, and with its fall it was natural to assume that the burdens peculiar to the past would no longer be continued.

It must also be remembered in this connection that the

* Quoted from Eheberg in article on Finance in Conrad's *Handwörterbuch*.

† Quoted from Roscher, *Finanzwissenschaft*, p. 495.

philosophy of the early part of this century assumed to regard all government as evil, and proposed to substitute for it the principle of self-interest and voluntary association. One who believes in *laissez-faire* must conclude that a reasonable people will narrow, so far as possible, the functions of government, and that the expenditures of the State will, in consequence, be curtailed. This was the accepted doctrine of the first years of this century, and it is not strange, the balance of power having been restored, that the statesmen of Europe expected a reduction of public expenditures.

The third fact to be held in mind is that previous to the present century land had been the chief reliance of the fiscal system. Agriculture was the principal industry of the people, and it was difficult to see, in the light of its slow development, what new sources of income could be opened should the government desire to expand its functions. Even Macaulay did not appreciate how rapidly national wealth was to grow.

In these three facts, then, do we find an explanation of the sanguine view with which financiers and statesmen regarded the nineteenth century at the close of the Napoleonic wars: (1) the people had gained influence in the State, and it was not foreseen that they would be as powerfully swayed by the spirit of national ambition as had been the rule of absolutism which they had overthrown; (2) the theory of social autonomy had succeeded to the practice of minute administration, and with the curtailment of public duties it was reasonable to expect a curtailment of public expenditures, and (3) to these natural errors in judgment must be added the fact that the wonderful expansion of industrial life, and the resultant changes in the structure of society, lay beyond the horizon of the most astute observer.

16. Public Expenditures Since 1830.—While it is true that the termination of the Napoleonic wars brought to a close the period in which military and court expenditures formed the most considerable item in the ordinary budget, it is also true that it marked the beginning of a new fiscal period; and, in considering the facts of public expenditures, so far as reflected in reliable data, it may be well to notice, first, the increase in national expenditures since 1830.

The past sixty years possess an industrial and political

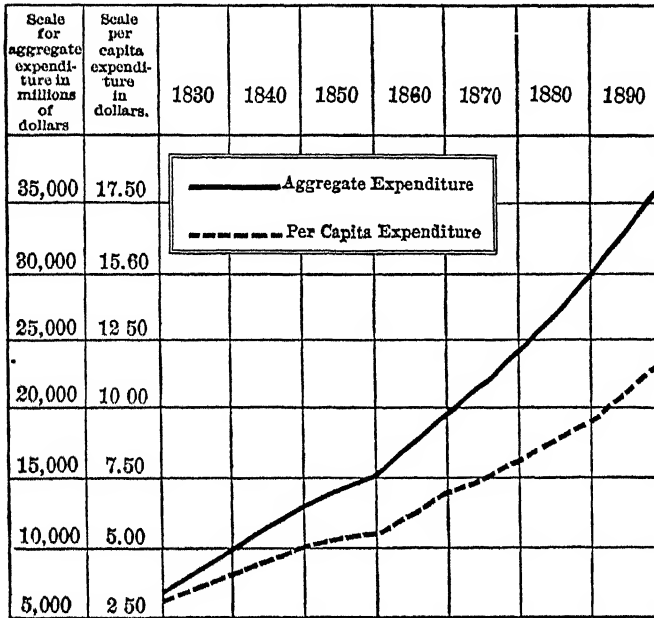
character peculiarly their own. The year 1830 is recognised by students of industrial history as the beginning of that form of industrial organization which is the peculiar product of the nineteenth century, and which doubtless will be the permanent characteristic of the century upon which we are about to enter. The industrial revolution began, it is true, with the period of inventions in 1760. But invention in the domain of production could never have wrought those changes which marked the revolution of modern industry had it not been for the development of modern methods of transportation. This is no place to trace the results of railways and steam navigation. Suffice it to say that the industrial world has been changed thereby, or ultimately will be changed, from an aggregation of local centres to a condition of national industry. New social forces, as well as new conditions for the prosecution of industry, were introduced with steam transportation; and the year 1830 is the year, if a single date must be chosen, for an event that in reality spread itself over a series of years, in which the commercial world began to realize the excellence of railways and of steam navigation, and their significance for industry and trade. It is natural to expect that so momentous an event would be reflected in public administration and in the finances of the State.

What, now, are the facts of public expenditure since 1830? So far as the more important countries are concerned, national expenditures may be traced with some degree of accuracy. Local expenditures present greater difficulties. On page 87 will be found a graphic statement of the increase in the national expenditure of European states from 1830 to 1890. The data for this diagram are taken, for the most part, from Mulhall.* While it is doubtless true that this writer possesses a gift for combination and estimate that few statisticians care to imitate, a somewhat careful scrutiny warrants the conclusion that in the present case the impression left by the diagram is a correct one.

From the statement given it appears that public expenditures in Europe have increased from \$955,000,000 in 1830 to \$3,600,000,000 in 1890, being an increase of 360 per cent dur-

* *Dictionary of Statistics.*

ing the sixty years named. It is also to be observed that the rise in the curve of increased expenditure is more marked with each succeeding decade.



The diagram shows also the per capita increase in expenditure for European states. Beginning with a charge of less than \$4 per capita in 1830, expenditures have risen to something over \$11 per capita in 1890. It is thus evident that the increase in population has not kept pace with the increase in national expenditures, a tendency which would be emphasized if to national expenditures the cost of local government were added.

It must not be assumed that the curve in the above diagram reflects the course of expenditures in any individual State. Each government is subject to the exigencies of its own conditions, and if studied independently will disclose a curve peculiarly its own. It is manifestly impossible to undertake such a study in a curtailed treatise. For the purpose of a more definite impression, however, there is inserted in the next summary a statement of expenditures for a few

selected nations, so far as continuity of political life and reliable statements respecting the cost of government permit. The classification was suggested by Fournier de Flaix, in his *Traité de Critique et de Statistique Comparée des Institutions Financières*, who divides modern states into three classes as introductory to the study of their representative financial systems. His classification is as follows: "First, those new states where the abundance of resources corresponds to the relative youth of the states themselves; such is the case in the United States, Australia, the English colonies of Africa, and the Dominion of Canada. Second, those states which by comparison are more or less ancient, as Russia and Italy, where temporary penury of resources is a serious embarrassment to the solution of financial problems and to fiscal administration. Third, those states which enjoy full prosperity, as England and Germany, which on account of their constantly expanding economic development are in a situation to accomplish numberless changes in their financial organization and administration."

In the main this is an admirable classification, but for our purpose we venture to modify it in one particular. Youth or age in a nation is in itself a matter of relatively slight significance. The important factor which determines the ability of a people to spare a continually increasing amount for public expenditures, or which opens up to the nation the need of new expenditures, is found in the yet undeveloped resources of the nation. Or, to express this thought in another way, a per capita expenditure must be counted as great or small according to the probable growth of industry and wealth in the future. Now there are two elements that determine a nation's potential development. The first is measured by the per capita area of land, the second by the general grade of industrial intelligence and industrial skill; and the classification which we have adopted rests upon the possession by a people of one, or both, or neither of those elements of industrial progress. It is as follows:

Class I. Those nations that possess both undeveloped resources and a high degree of industrial intelligence, such as the United States, Australia, and in general all colonies other than those of Latin peoples.

Class II. Those nations that possess a high grade of in-

dustrial intelligence and no considerable amount of undeveloped resources, such as England, France, and Germany.

Class III. Those nations that possess undeveloped resources but no considerable industrial intelligence, such as Russia and most of the colonies of Latin peoples

Class IV. Those nations that possess neither undeveloped resources nor industrial intelligence of the first rank, such as Italy, Spain, Greece, and Austria-Hungary.[†]

Now it is clear that the same amount of per capita expenditure, or the same rate of increase in the per capita expenditure, cannot bear the same relative significance for all peoples. As the burden of what government expends at any particular time is measured against the social income, so the burden of a constantly increasing expenditure must be measured against the promise of a future industrial development. This being the case, the constantly increasing expenditures of nations should be regarded by them with solicitude in the order in which they are placed in the following summary of expenditures since 1830.

NATIONAL EXPENDITURES OF SELECTED STATES SINCE 1830.
IN MILLIONS OF DOLLARS.

| Class | States | Dates | | | | | | |
|-------|---------------------|-------|------|------|------|------|------|------|
| | | 1830 | 1840 | 1850 | 1860 | 1870 | 1880 | 1890 |
| I | { United States . . | 15 | 24 | 39 | 63 | 309 | 267 | 352 |
| | { Australia | .. | ... | . | 40 | 60 | 100 | 140 |
| II. | { United Kingdom.. | 275 | 260 | 275 | 345 | 340 | 400 | 430 |
| | { Germany | ... | ... | ... | ... | . | 135 | 320 |
| | { France.... . . | 201 | 285 | 300 | 405 | . | 620 | 685 |
| III. | { Russia | .. | | 220 | 312 | 380 | 533 | 759 |
| | { Mexico. | | ... | . | ... | .. | 23 | 38 |
| IV | { Italy | ... | ... | .. | 161 | 222 | 274 | 371 |
| | { Spain | 45 | 55 | 70 | 105 | 165 | 165 | 170 |
| | { Austria-Hungary | 90 | 140 | 185 | 225 | 295 | 375 | 420 |

In view of what is known of the industrial and political history of the nations whose expenditures are included in the

* I confess to some doubt as to the proper classification of Austria-Hungary in the above scheme.

above summary, there are quite a number of comments which present themselves for expression. Consider the ease with which the United States raised her ordinary expenditures from \$63,000,000 in 1860 to \$309,000,000 in 1870. Australia shows even greater lasticity in the expansion of expenditures. The cost of government at the present time means relatively less to these peoples than to any other peoples of the world, for not only do they have ample means to meet present expenditures, but they have both skill and natural resources for development in the future. This potential fiscal ability is a dangerous possession, for it invites carelessness in the control of public affairs, but it should also be remembered that it contains great promise.

Turning now to the second class of governments, it is evident that financial expansion in England was prior to the period covered by the above summary. This is true in industry as well as in finance, and it is at least possible that national expenditure in England since 1830 foreshadows what will prove to be the course of national expenditure in other countries. It is probable that the weight of national expenditures rests as lightly in England as in any other country. Even the per capita expenditure has not greatly increased. Germany seems to have taken upon herself new life since the establishment of the Empire. France, too, shows wonderful industrial attainments, but, owing to a slow increase in population, appears to labour more heavily under her increased expenditures than either of the other nations with which she is classed.

Little can be said of Russia, except that her financial strength lies in her immense population and her undeveloped natural resources. An analysis of her budget would show that the claims of the civilizing interests upon her annual expenditure are less than for most of the other nations of Europe. Of her aggregate expenditures 29.54 per cent is for the support of her debt, 25.44 per cent for public defence, while 3.80 per cent only is devoted to education and art. Her ambitions are primarily military, and when the character of her southeastern neighbours are held in mind it may be doubted if her budgets will show any considerable increase in expenditure for what we have termed the "developmental functions" until by her conquests she meets with a people as civilized as herself. To

suggest what would be the effect upon European budgets of the completion of the scheme of conquest which seems to be the destiny of Russia would be an unwarranted indulgence in speculation. One may, however, venture to assert that it would bring about a decided change in the ratio of military and non-military expenditures. The chief obstacle at the present time to the reduction of expenditures for the army and navy in Europe, and to the consequent expansion of that class of expenditures designed to raise the grade of common living, is found in the military ambition of Russia. Could that ambition be exhausted by the accomplishment of its aim, or could it be weakened by the growth of commercial interests among her people, the financial situation of Europe would be greatly relieved.

The above consideration leads naturally to a characterization of the financial situation of such countries as Italy, Spain, and Austria. These peoples have neither undeveloped resources, as is the case in Australia, nor do they possess a high grade of industrial and commercial activity, as is the case in England, but the expenditures which they are called upon to meet are nevertheless constantly increasing. By virtue of their intelligence they should rank with the best industrial peoples of Europe, but by virtue of their "temporary penury," to quote Fournier de Flaix, their ability to establish a rational scheme of expenditures is seriously embarrassed. They need to invest large sums for the development of such resources as they possess and for the industrial education of their people; they find themselves obliged to acknowledge military expenditures as relatively more important, and to drain the earnings of their citizens for an unprofitable investment of the nation's capital. These are the peoples who feel most seriously the burden of increasing expenditures, since for them it means delay in reforms which they regard as important, and in the attainment of a higher plane of living by their people.

These observations have perhaps been sufficiently extended to impress upon the reader the fact that while there may be a fundamental social law reflected in public expenditures, the conditions under which that law asserts itself are so various that the significance of a given amount of expenditure or of a given tendency in expenditures must be peculiar

for any particular nation studied. Our further investigation will confine itself for the most part to those nations that have fairly ample resources at their command.

17. Public Expenditures and Wealth—No statement of the tendency in public expenditures is complete that fails to compare the increase in expenditures with the increase of wealth. It is not possible to arrive at a satisfactory estimate of wealth for any considerable number of people. The statements that follow are confined to the United States, Great Britain, and France. Since the dates for which reliable estimates of wealth may be obtained are not the same for each nation, no attempt is made at a single uniform statement.

NATIONAL EXPENDITURES OF THE UNITED STATES COMPARED
WITH POPULATION AND PROPERTY BY CENSUS YEARS 1840
TO 1890, INCLUSIVE

| Date | Population.* | Property * | Property per Capita | National Expenditures † | Expenditure per Capita | Percentage of Expenditures to Property. |
|------|--------------|-----------------|------------------------|----------------------------|------------------------------|---|
| 1840 | 17,069,000 | ... | ... | \$24,000,000 | \$1.42 | ... |
| 1850 | 23,191,000 | \$7,135,000,000 | \$308 | 39,000,000 | 1.71 | .0054 |
| 1860 | 31,443,000 | 16,159,000,000 | 514 | 63,000,000 | 2.01 | .0039 |
| 1870 | 38,558,000 | 30,068,000,000 | 780 | 309,000,000 | 8.03 | .0103 |
| 1880 | 50,155,000 | 43,642,000,000 | 870 | 267,000,000 | 5.34 | .0061 |
| 1890 | 62,622,000 | 65,037,000,000 | 1,036 | 320,000,000 | 5.07 | .0041 |

* United States Census Reports.

† Revised Treasury Statements, net amounts.

NATIONAL EXPENDITURES OF THE UNITED KINGDOM COMPARED
WITH POPULATION AND PROPERTY FOR DATES NAMED.

| Dates. | Population. | Property.* | Property per Capita | Expenditures | Expenditure per Capita. | Percentage of Expenditures to Property. |
|--------|-------------|----------------|------------------------|--------------|-------------------------------|---|
| 1822 | 21,000,000 | £2,500,000,000 | £120 | £58,000,000 | £3.41 | .0228 |
| 1845 | 28,000,000 | 4,000,000,000 | 143 | 56,000,000 | 2.00 | .0140 |
| 1865 | 30,000,000 | 6,000,000,000 | 200 | 65,000,000 | 2.16 | .0108 |
| 1890 | 37,000,000 | 10,000,000,000 | 270 | 86,000,000 | 2.32 | .0086 |

* Giffen, *The Growth of Capital*, p. 110.

NATIONAL EXPENDITURES OF FRANCE COMPARED WITH
POPULATION AND PROPERTY FOR DATES NAMED.

| Dates | Population * | Property † Fr. | Property per Capita. Fr. | Expenditures Fr. | Expenditure per Capita Fr. | Percent- age of Expendi- tures to Property. |
|-------|--------------|-------------------|-----------------------------------|---------------------|-------------------------------------|---|
| 1853 | 36,108,000 | 125,000,000,000 | 3,462 | ... | ... | ... |
| 1871 | 36,544,000 | 175,000,000,000 | 4,794 | 3,046,000,000 | 83.35 | .0174 |
| 1878 | 37,212,000 | 200,000,000,000 | 5,374 | 3,348,000,000 | 89.94 | .0167 |
| 1886 | 38,219,000 | 200,000,000,000 | 5,233 | 3,294,000,000 | 86.18 | .0164 |

* De Foville, *La France Économique*, p. 9

† De Foville, *La France Économique*, p. 516

The exhibit submitted for the United States does not extend beyond the year 1840, and the first safe estimate of wealth is for the year 1850. Nor would it be desirable, were it possible, in this somewhat cursory survey of the subject, to enter upon an investigation of the early years of this century. There is little in common between the industrial character of the period prior to 1840 and that of the period subsequent to it. While it is true that machinery was, to some extent, employed in the earlier years, it cannot be said that society was in any marked degree influenced by the development of the factory system. When, however, we confine our attention to the fifty years subsequent to 1840 no country reflects so clearly in its financial and industrial history the character-giving forces of the nineteenth century as does the United States.

The exhibit for the United Kingdom extends from 1822 to 1890, and represents a continuity of political and industrial life for sixty-eight years. It will be remembered that England stands as the most advanced industrial nation of the world, that in 1822 her wealth was very considerable when placed in comparison with that of other nations, and that the period of her expansion in national expenditures was during the Napoleonic wars.

The statement for France covers the years from 1853 to 1886. The estimates of property appear to meet the approval of M. de Foville,* those of 1878 and 1886 being the result of

* Alf. de Foville, *La France Économique Statistique Raisonnée et Comparative*, p. 515.

his own computations. A calculation based upon the returns of succession duties warrants Mr. Giffen in asserting "that the growth of property in France has been very rapid, as rapid during the present century as in the United Kingdom" * For the last twenty years, however, it may be doubted if there has been any marked increase in money values in France, from which it appears that any further expansion of public expenditures must tend to become a serious matter for the French people.

The data presented in the above summaries will serve as a corrective to some of the erroneous applications that have been made of the general fact that public expenditures tend constantly to increase. Of the three nations subjected to analysis the tendency has been for property to increase at a rate relatively more rapid than national expenditures; and for the United States the growth of population also appears to be more rapid than national expenditures. This fact leads to several important conclusions which, regarded as contributions to the practical rules for fiscal administration or as a statement of current sociological tendencies, are believed to be new as well as important.

In the first place, while it is true that public expenditures have continuously expanded, it is not true that they have become correspondingly more burdensome; and should the financier discover that the fiscal system rests with ever-increasing weight on industry as time goes on, he must look for an explanation of so culpable a result to the structure of that system and to the manner in which it makes appeal to the citizen for payment rather than to the amount which it demands. This remark cannot be construed as in any sense an apology for unnecessary expenditure. It is no excuse for lavish appropriations that the government leaves relatively more in the hands of the people each year than it takes from them. It does, however, direct attention to the truth, too frequently overlooked, that the burden of the fiscal system lies rather in the rules adopted for collecting revenue than in the amount of revenue collected—a truth of especial pertinence to the fiscal conditions of the States, municipalities, and minor civil divisions in this country.

* Robert Giffen, *The Growth of Capital*, p. 131.

The second observation suggested by the data contained in the above table is that the expansion of public expenditures does not call for a corresponding expansion of the basis of taxation. The facts in the case give no support to the assumption so generally applied in the reasoning of financiers that a continually larger number of sources of revenue must be opened to supply the growing demands of the State*. On the contrary, the growth of property at a rate more rapid than the development of the demands of government would lead to the conclusion that, other things being equal, the increase in public expenditures might be met even though the basis of the fiscal system were narrowed year by year. The practical conclusion from this is that the financier performs his whole duty when he meets current demands without impairing the patrimony of the State, and without obstructing the development of national riches. When it comes to questions of investment he is doubtless obliged to have regard to the future, but so far as current ordinary demands are concerned he may limit the horizon of his observation to the present. The "elasticity of revenue" necessitated by the "law of increasing expenditures" is amply provided for so long as wealth tends to outstrip expenditure in its growth.

The third observation is sociologic in character. The facts portrayed in the above statement do not lend their support to the prevailing idea that government in these later days is encroaching upon the domain of private initiative, and that coercive association is expanding more rapidly than voluntary association. Were this true it might indeed be the occasion for alarm to those who believe that the continuance of our present form of society demands a stable balance between governmental and private activities. The impression that government is growing at the expense of private association is doubtless due to the rapid expansion in certain directions of governmental functions; but it should be held in mind that this is balanced by an equally rapid expansion of functions non-governmental in character. The proof of this assertion is found in the fact that among peoples of a high grade of industrial attainment public expenditures do not increase at so rapid a rate as the property from which they are

* Cf. article on Finance by Dr. Edmund J. James in *Cyclopædia of Political Science*.

met, and when it is recognised that a continually larger share of social income exists in the form of earnings from labour and enterprise rather than as earnings from capital, it is also clear that public expenditures do not increase at so rapid a rate as social income. The financial statistics of governmental administration offer no proof of the assertion that the development of public functions tends in any degree to destroy the established balance between public and private activities.

18. Growth of Local Expenditures. — It is clear what the tendency in local expenditures ought to be if the analysis of governmental functions presented in the foregoing chapter, and of the shifting of their relative importance with increased differentiation of social functions, be correct. It was there claimed that "expenditures for the developmental functions tend constantly to increase." It would not be correct to assert that local expenditures are exclusively assigned to the support of the developmental activities, and national expenditures to the protective activities, of government. The large appropriations for rivers and harbours by Congress in the United States, or for schoolhouses and education by the Assembly in France, would contradict such a generalization. Notwithstanding numerous exceptions, however, it remains true that the developmental functions predominate over the protective functions in local government, while the protective functions predominate over the developmental functions in national government; from which it follows that the relative increase in local and national expenditures may be accepted as a test of that portion of our general theory of public expenditures which pertains to the developmental functions of the State. With this explanation the summary on page 97, which gives the percentage of national and local expenditures for the United States, the United Kingdom, and France during the past half-century, must be accepted as significant.

There seems to be no doubt respecting the modern tendency in local expenditures. In France there has been a steady increase in the percentage of local expenditures, and a relative decrease in the percentage of national expenditures, since 1864. In the United Kingdom, with the exception of the period in which national expenditures were influenced by the Crimean War, the same tendency may be discerned; while in the

STATEMENT OF THE PERCENTAGE OF NATIONAL AND LOCAL EXPENDITURES FOR SELECTED DATES FOR COUNTRIES NAMED.

| Countries and Dates. | | Percentage of Expenditures | |
|----------------------|---------------|----------------------------|-------|
| | | National | Local |
| United States | { 1850 | 49 | 51 |
| | { 1860 | 39 | 61 |
| | { 1870 | 53 | 47 |
| | { 1880 | 47 | 53 |
| | { 1890* | 39 | 61 |
| United Kingdom | { 1840 | 84 | 16 |
| | { 1850 | 81 | 19 |
| | { 1860 | 82 | 18 |
| | { 1870 | 66 | 34 |
| | { 1880 | 58 | 42 |
| France | { 1864 | 87 | 13 |
| | { 1876 | 79 | 21 |
| | { 1890 | 70 | 30 |

United States, again making an exception for the influence of the war of 1861, the figures exhibit the same trend. It is of course recognised that population has massed itself in cities during the period under consideration. It is also recognised that municipal corruption, especially in the United States, has exerted considerable influence upon municipal expenditures.

*NATIONAL AND LOCAL EXPENDITURES OF THE UNITED STATES FOR THE YEAR 1890.

| Organs of the State charged with Expenditure | Amount | Per Capita | Per Cent. |
|--|-------------|------------|-----------|
| National government, including postal service | 352,218,614 | 1 62 | 39 |
| States and territories, except for common schools | 77,105,911 | 1 23 | 9 |
| Counties, except for common schools | 114,575,401 | 1 83 | 12 |
| Municipalities, except for common schools ¹ | 232,988,592 | 3 72 | 25 |
| Public common schools | 139,065,537 | 2 22 | 15 |
| Aggregates | 915,954,055 | 14 62 | 100 |

¹ Commercial enterprises are included only in case of net deficits.

A student of municipal government would assert, further, and very properly, that the increase in local expenditures represents in part an investment of public capital in municipal public works. But, making liberal allowance for these considerations, so far as they contradict our generalization, it yet remains true that the increase in local expenditures at a rate more rapid than the increase in national expenditures illustrates, if it does not prove, the rapid growth of the developmental activities of the State. As has been already pointed out, a very considerable portion of the increment of expenditure assigned for the support of the police power has furnished the means for the expansion of developmental functions.

Other nations besides those included in the above summary present the same tendency. In Belgium,* for example, there has been a growth in the local expenditures of the great cities during the twelve years prior to 1890 of 55 per cent. According to Herrfurth, the per capita of expenditures in Prussia for local purposes in 1849 was 3.77 marks; in 1869, 6.47 marks; in 1876, 9.58 marks, in 1880, 10.53 marks; in 1884, 11.46 marks. The tendency seems to be universal, and it may be accepted as a general truth that expenditures for local purposes are increasing at an unusually rapid rate.

According to the analysis of the previous chapter, developmental functions present themselves under five general heads. It is not possible, on account of the diverse classification followed in public reports, to submit a comprehensive statement of the movement in expenditures incident to these several services. As illustrative of the tendency, however, a few facts are here presented respecting the increase in expenditure for educational purposes. Even this statement must be limited and fragmentary. In the United States the amount of money which was expended for educational purposes for public common schools in the year 1890 was \$145,583,115. This is equal to nearly 17 per cent of the aggregate expenditures. The only item of expenditure in excess of education is "pensions, charities, and gratuities"; and, as every student of current history knows, the pension payments of the United States could never have reached their present figure had it

* Eheberg, article "Finanzen," Conrad's *Handwörterbuch der Staatswissenschaften*.

AGGREGATE NATIONAL AND LOCAL EXPENDITURES

| No. | Administration Classification of Expenditures. | Amounts |
|-----|--|---------------|
| 1 | Pensions, charities, and gratuities | \$146,895,671 |
| 2 | Educational purposes and public common schools. | 145,583,115 |
| 3 | Interest on debt | 82,748,423 |
| 4 | Roads, sewers, ditches, and bridges | 72,262,023 |
| 5 | Postal service | 66,259,547 |
| 6 | New buildings, works, and sites, construction and purchase separately reported | 38,890,970 |
| 7 | Salaries, separately reported, fees, and commissions | 37,552,655 |
| 8 | Military purposes.. . . . | 35,537,611 |
| 9 | Police | 23,934,376 |
| 10 | Judiciary, including county courts, inquests, and inquiries | 23,071,075 |
| 11 | Public buildings and sites, care and maintenance, including construction not separately reported | 17,950,177 |
| 12 | Executive department | 16,770,801 |
| 13 | Fire | 16,423,820 |
| 14 | Naval establishment, except for new vessels | 15,174,403 |
| 15 | Penal and reformatory institutions | 12,381,425 |
| 16 | Improving harbours and rivers | 11,737,438 |
| 17 | Lighting | 11,363,780 |
| 18 | Congress and legislative | 10,485,826 |
| 19 | Constructing new war vessels. | 6,831,803 |
| 20 | Indians | 6,708,047 |
| 21 | Health | 3,280,294 |
| 22 | Public parks and places | 2,962,697 |
| 23 | Foreign intercourse. | 1,648,277 |
| 24 | Miscellaneous... | 109,499,801 |

for which the payment provides. In the case of interest, for example, it would be necessary to know how the proceeds of the loans supported by the interest were expended in order to classify the payments. So far as this interest supports national obligations, it probably should be assigned to the protective activities of the State, so far, however, as it supports State and municipal obligations, it should be assigned either to the commercial or the developmental activities. The same is true also of the expenditures of the Executive Department or of the expenditure for the support of Congress and the State legislatures. The amount paid for the support of these branches of government is common to the three classes of public functions, and should be distributed among them

OF THE UNITED STATES, 1890.

| Classification of Expenditures as Protective, Commercial, and Developmental. | No. |
|--|-----|
| Commonly regarded as protective | 1 |
| Developmental | 2 |
| Depends on use of proceeds of debt | 3 |
| Developmental. | 4 |
| Commercial | 5 |
| Developmental primarily..... | 6 |
| Depends on service performed | 7 |
| Protective..... | 8 |
| Protective primarily.. .. | 9 |
| Protective primarily | 10 |
| Developmental primarily.... | 11 |
| Calls for distribution | 12 |
| Protective... .. | 13 |
| Protective | 14 |
| Protective and developmental..... | 15 |
| Developmental. | 16 |
| Protective and developmental | 17 |
| Calls for distribution | 18 |
| Protective | 19 |
| Protective | 20 |
| Protective primarily .. | 21 |
| Developmental .. | 22 |
| Protective and developmental..... | 23 |
| | ... |

It will also be observed that, in the light of our analysis of public activities, certain of the items of expenditure are common to the protective and the developmental functions. Such, for example, is the cost of the police service or of the penal or reformatory institutions. Even the public lighting, which primarily was undertaken for the purpose of greater security, is capable of being interpreted in part as ministering to social development. The separation between the various classes of activities is much clearer for the purpose of analysis than for the purpose of administration, but it is impossible for one to review even this administrative analysis of public expenditures without being impressed with the fact that one of the ruling considerations in the determination of public

expenditures is the purpose on the part of those who administer public affairs to provide for the State a healthful growth and for society an orderly development. It is the social ideals rather than the social necessities which are coming to determine the amount of money placed at the disposal of the State.

BOOK II.

BUDGETS AND BUDGETARY LEGISLATION.

CHAPTER I.

GENERAL CONCEPTION RESPECTING BUDGETS.

CONCERNING THE MEANING OF THE WORD BUDGET

CONCERNING THE RELATION OF BUDGETS TO CONSTITUTIONAL GOVERNMENT

- (1) General Considerations
- (2) Basis of Budget Right in England.
- (3) Basis of Budget Right in France.
- (4) Basis of Budget Right in Germany.
- (5) Basis of Budget Right in the United States.

As pointed out in the Introductory Chapter to this treatise, the most fruitful source of financial disorder is found in the carelessness and uncertainty likely to attend financial legislation; and it is an appropriate task for the Science of Finance to consider somewhat at length those parliamentary rules designed to render the several steps in financial legislation certain and clear, as also those constitutional provisions by which publicity may be secured and responsibility realized. The evils of which complaint is made are, for the most part, beyond the domain of statutory enactment, and consequently the political remedy must be relied upon for holding them in check. In order that this remedy may be effective, and that they who vote taxes and legalize appropriations may do so with a just regard to public interest, it is essential that certain general rules of procedure should be laid down before the business of fiscal legislation be entered upon. A consideration of these rules and all that they imply, both historically and analytically, is now entered upon; and, in conformity with accepted

nomenclature, is presented under the name of Budgets and Budgetary Legislation

20. The Meaning of the Word Budget.—The origin of the word budget is perhaps of antiquarian rather than scientific interest. "The word *budget*, *bouge*, or *bougett*, according to Pasquier and other ancient authorities, as well as in the old language of Rabelais, is derived from the Latin word *bulga*, become Gallic, which expressed a bag, a pocket, a purse. Its origin is therefore Latin and French. England has applied it to the great leather bag which for a long time contained the documents presented to Parliament to explain the resources and the wants of the country." * The transition in the meaning of this word from the bag carried by the treasurer to the documents which the bag contained, and finally to the scheme of rights and rules of procedure which arise in connection with their use, was a most natural one in view of the paramount importance of carefully drawn and detailed documents for sound financial administration. When in 1803 the word appeared for the first time in French financial nomenclature it was used as a substitute for the phrase "estimates of receipts and expenditures." The desire to substitute this somewhat indefinite word for a definite expression is possibly explained by the fact that the phrase "estimates of receipts and expenditures" was joined in the minds of the French people to the financial abuses of the ancient *régime*, while the word budget had been dignified by the rôle it had played in England in the development of constitutional government. This incident in French financial history should at least suggest to our minds what is undoubtedly true, that the word budget is more comprehensive than a report upon the income and expenditures of the State. An estimate of income and expenditures is possible for the individual or for the sovereign who conceives of the State as a private property, but a public budget, as that phrase is interpreted by modern political development, is impossible except for a people which enjoys, in some degree at least, the constitutional right of placing a limit to public income and of exercising a control over public expenditures.

Without undertaking a formal definition of the word

* Cf. *Journal of the Statistical Society of London*, Vol. XXIX, p. 325.

budget it may be well to consider one or two of its general characteristics as preliminary to a comparative study of the several forms which budgets have assumed among various peoples. In its formative stage the budget is a report upon a nation's finances designed primarily to show to the legislator the condition of the public treasury and the fiscal needs of the State. This is true whether the government in question be imperial or democratic. If imperial the report will be made by the monarch in his capacity as administrator to himself in his capacity as legislator, if democratic it will be made by the administrative to the legislative department of government. The aim of this report is to give information to the legislative body, and this fact determines many of the technical questions which arise respecting it*.

The budget regarded as a report for the information of the legislature will cover at least twice the fiscal period, that is to say, it will contain a statement of the results of the operation of fiscal laws during the period closed, and an estimate of what reasonably may be expected during the period to come. These two parts of the budget are sometimes called the executed and the estimated budgets. The former enables the legislator to determine the adequacy of existing fiscal laws, and to judge of the efficiency and economy of those who administer them, the latter is made the basis of current legislation.

If in its first stage the budget is a report, in its second stage it becomes a project of law. The conversion of the report into a legislative bill is a process respecting which one can make no very definite statement except the political conditions and parliamentary methods of some particular people be held in mind. Nor is this the point that should claim the attention of the student. The essential fact is that a report upon past fiscal operations must precede new fiscal legislation.

The comprehensive nature of budgets, however, is not suggested by regarding them either as a report or as a project of law, they must be conceived as a part of the political machinery essential to the realization of the ideal of popular government before their dignity and importance can be adequately appreciated. Inasmuch as the avowed purpose

* For a series of definitions see Stourm's *Le Budget, son histoire et son mécanisme*, § 1.

of budgets is to secure care and economy in fiscal legislation, so far as that is dependent on an orderly method of procedure, it follows that a comprehensive study of budgets will embrace a consideration of those parliamentary rules and laws of administration designed to further this end. This being the case, the study of the budget comes to be a study of administrative and parliamentary organization and procedure; and since this in turn is dependent on the fundamental organization of states, it will be necessary to make frequent references for the purpose of explanation and argument to the accepted principles of constitutional government regarded as an ideal, and to the peculiar requirements of the constitutional provisions of particular peoples by which that ideal is worked out. Here, indeed, is the starting-point, historically as well as analytically, for an investigation into budgets and budgetary legislation.

21. The Relation of Budgets to Constitutional Government.—The relation between budgetary regulations and the ideal of personal rights and social relations underlying popular government is a very close one. Budgets, indeed, are one of the most important means through which those ideals are realized in public administration. It is an old saying that political power lies with whomsoever holds the public purse, and it is the first lesson of history that the struggle for constitutional government has, in large measure, been confined to the question of control over fiscal affairs. It may be well to refer to a few familiar instances which illustrate this point.

(1) *General Considerations.*—As early as 1215 in England it was asserted as an ancient right that the king could not demand payment or service from his subjects in an arbitrary manner. The twelfth article of the Magna Charta reads as follows: "No scutage or aid shall be imposed in the kingdom, unless by the Common Council of the realm, except for the purpose of ransoming the king's person, making his first-born son a knight, and marrying his eldest daughter once, and the aids for these purposes shall be reasonable in amount." By the fourteenth article, in case a general council is deemed necessary to take into consideration the question of aids, the king is bound to issue a formal summons to those who have a right to meet in council, and to state in the summons the

cause for which the council is convened. In these articles may be found an assertion of an ancient right, that without the consent of the subjects no imposts could be levied. This assertion doubtless bore a very different meaning in the thirteenth century from its interpretation under modern political conditions, but it shows that the principle of control over government through control over the sources of revenue is a very ancient one.

As bearing upon this point Creasy says: "Among all the nations of the Gothic stock, whether of its Scandinavian or of its Teutonic branch, and in all the kingdoms founded by them out of conquered Roman provinces, councils or assemblies of some form existed, whose consent the ruling chief was bound to obtain in order to legalize all important measures of State. We have already drawn attention to the assemblies of the principes, and the general assemblies of freemen among the primitive Germans, and to the Tings of the primitive Danes. The student may also here usefully refer to what has been said respecting the witenagemotes of the Anglo-Saxons. At least he must bear in mind that it was only with the sanction of this witan that an Anglo-Saxon king could make new laws or impose new taxes, that the prelates and the great nobles and thanes attended these assemblies, and that the inferior class, the ceorls, though not directly represented there, yet were not without protectors and advocates, inasmuch as certain of the magistrates whom the men of every borough and township regularly elected from among themselves for the purpose of local self-government might be present at the witan for the purpose of obtaining redress for any wrong which might have been committed, and for the redress of which the ordinary tribunals were inadequate. When once present at the witan, though ostensibly only for the purpose of remedial justice, the ceorl magistrates must have had some influence in other matters also, inasmuch as the cheerful co-operation of the bulk of the community in carrying any particular measure into effect never can be thought immaterial, even by those who have the power of enforcing sullen obedience. The Anglo-Saxon polity was overthrown by the conquering Normans; but the recollection of this virtual though indirect system of representation must have survived among the bulk of the population, and may have greatly

facilitated the adoption and insured the good working of the subsequent parliamentary representation of the commons.” *

In France as well as in England appeal was made to the same principle as a principle of ancient establishment. In 1787 the right of control by the people over revenue in France was declared to be one of the “primitive laws of the State.” In an address by the President of the Parliament of Paris to the king are found the following words. “The constitutional principle of the French monarchy is that all imposts should be consented to by those who are called upon to support them. It is not, sire, in the heart of a beneficent king to alter this principle which holds to the primitive laws of your State. . . . If your Parliament has for many years believed that it was able to answer for the obedience of the people in matters of impost it has more frequently consulted its zeal than its power.” †

The great charter of Holland, also, the origin of which, according to Beaulieu, “is lost in the night of time,” imposed upon the executive the duty of coming in person before the assembly should he desire a grant of money. Many other citations might be made in evidence of the antiquity and universality among all peoples of Western civilization of this fundamental principle which, historically at least, must be regarded as the basis of all budgetary legislation.

The relation of fiscal affairs to the development of constitutional government appears most clearly in connection with the later history of the English people. After the downfall of feudalism, and the consequent political enfranchisement of the great body of the people, a struggle arose between the sovereign, who claimed exclusive privileges, and the commons, who claimed to represent the people. It was the principle of democracy arrayed against the principle of monarchy; and as the feudal lords on the occasion of the Great Charter asserted as a primitive right the right of consenting to supplies, so now the representatives of the nation asserted as an inheritance of the past this same primitive right. The struggle between the commons and the crown is too familiar a chapter of history to warrant our dwelling at this

* Creasy, *The Rise and Progress of the English Constitution*, pp. 183, 184.

† Leroy-Beaulieu, *Traité de la Science des Finances*, Vol. II, p. 4.

time upon the events which it narrates. The result of that struggle was a concession to the commons of the right of control over the source of public supplies.

Speaking, then, historically and for peoples whose governments recognise constitutional limitations, the budget is not merely a report from the administrator to the legislature upon the finances of the country, but it involves a constitutional right that such a report shall be made in order that the people may control the finances of the nation^{*}. Indeed, the extent to which this right is recognised may be regarded as one of the surest indications of the degree to which popular government is developed. The fundamental law of every State which pretends to enter upon a constitutional *régime* contains some specific mention respecting the fiscal rights of the people, or of the popular legislative branch which is commonly accepted as representing in a peculiar manner the interests of the people, and as preliminary to the further study of budgets it may be well to consider briefly the form in which these rights are expressed.

(2) *Basis of Budget Right in England*—In England the constitutional fiscal rights of the House of Commons are three and as follows.

First. The right of consenting to the imposition of taxes, of raising the rate of existing taxes, or of the renewal of periodic taxes.

Second. The right of consenting to public loans in every case.

Third. The right of consenting to expenditures; that is, of making specific grants for specific purposes, and of limiting

* The importance of the right of popular control over finance to a well-administered State has never been more vigorously expressed than by de Tocqueville in his treatise upon *L'ancien régime à la révolution*. He says "I dare to affirm that upon that day when the nation, fatigued by the long disorders which accompanied the activities of King John and the fall of Charles the Sixth, permitted the kings to establish an impost without its consent, and when the nobility had the cowardice to permit the third estate to be taxed provided only that it itself was exempt—on that day there were sown the seeds of all the vices and all the abuses which worked themselves out in the ancient *régime* during the rest of its life and which caused its violent death"—Stourm, *Le Budget*, p. 35.

such grants to a specific time Such is the legal basis of the English budget.

(3) *Basis of Budget Right in France* —Since the Revolution of 1787 the French people have lived under eighteen different constitutions, all of them, however, recognise the right of the representatives of the people to control fiscal affairs. Although the form of government in France may still be regarded as a political question, the lesson of absolutism seems to have been thoroughly learned, and all the constitutions of the present century have been in substantial conformity with the principles laid down in the Constitution of 1787, so far as questions of fiscal right and procedure are concerned. This principle was also asserted in the Declaration of Rights. In Art. XIV, sec. 9, of that Declaration may be found the following: "All citizens have the right of proving either by themselves or their representatives the necessities of public contributions, to consent to them freely, to scrutinize their employment, to determine their amount, their assessment, their collection, and their duration."

The Constitution of 1789 had three statements which may be accepted as the basis of the French budgetary system:

First. It is stated in section 5 that no tax, impost, charge, duty, or subsidy can be established without the free consent of the representatives of the nation.

Second. It is stated in Article VI that the representatives of the nation ought to hold surveillance over the employment of subsidies. In consequence the administration ought to render a strict account to them.

Third. It is stated in Article VII that the ministers and the other agents of royal authority are responsible for every infraction which they commit against the laws, whatever may be the order they have received.

(4) *Basis of Budget Right in Germany*.—It lies in the theory of the German Government that the representatives of the people should control expenditures, although the machinery for working out that control is not as yet fully developed. The principle finds expression in the Prussian Constitution of 1850, which grants in a definite manner to the representatives of the country the right to control through their vote public receipts and public expenditures, and German publicists are fond of narrating the following incident as proof of the

loyalty with which this constitutional provision is regarded. In 1862, a plan for reorganizing the army having been submitted, the deputies of the Prussian Landtag refused to make an appropriation for carrying out the proposed reorganization. Without narrating the incident in detail, or reviewing the arguments by which the measure was urged, it is sufficient to say that the reorganization of the army was carried through without the consent of the representatives of the people. The question was a matter of controversy for several years. When, however, in 1866 the battle of Sadowa demonstrated the merit of the reforms in the military by the victory of Prussia over Austria, and the Prussian people in consequence were well disposed toward the government, the king of Prussia asked the pardon of the deputies for his illegal act. "The public expenses made during this period," said the king, "were without legal sanction," and he requested of the Landtag a vote to legalize what the government had thought it wise to do. It would be foolish to grant to this incident all the significance which the German publicists assert for it, but it at least shows that the constitutional lawyers of the Prussian kingdom did not regard success an adequate sanction for the fracture of a clearly expressed constitutional provision.

In the Constitution of the German Empire adopted in 1871 the following articles are to be observed as bearing upon the legalization of financial measures.

Article 69 affirms that "all income and expenditure of the empire must each year be estimated and brought into the imperial accounts." This, it will be noticed, does not state that all income and expenditure must be voted each year, but that the budget, so far as it is a report, must be comprehensive and complete. Article 70 defines the sources of imperial income. Article 71 states that common expenditures must, as a rule, be agreed to (*bewilligt*) each year, although in certain cases a grant extending for a longer period may be allowed. Article 72 imposes upon the Imperial Chancellor the duty of laying before the Bundesrath and Reichstag an annual statement respecting the expenditure of the imperial income.

These articles, like all constitutional provisions, bear the meaning placed upon them by the laws passed to secure their enforcement, but a casual reading must give rise to the

impression that the influence of the people upon the general policy of government by means of their control over income and expenditure through the popular branch of the government—that is to say, the Reichstag—is much less direct than in the case of England or France, and this impression will be strengthened when the nature of that influence is subjected to a more careful analysis. No special provisions are made for the enactment of financial laws, these being regarded in all particulars in the same manner as other legislative enactments, and subject to the general rules which control the exercise of legislative power. Indeed, it is a significant fact that the articles of the Constitution referred to above, and which may be regarded as providing the basis of German budgetary legislation, pertain primarily to matters of administration rather than to questions of fundamental right. The “agreeing” to appropriations provided for in Article 71 is, from the constitutional point of view, an essentially different act from the consent of the House of Commons in the case of English fiscal legislation, as will be seen when the effect of a failure to agree, or to consent, to proposed governmental measures in the two countries is considered.

It should be noted further that the Constitution itself is regarded as complementary to the fundamental provisions of the established institutions of the land, and must be interpreted in the light of its relation to these institutions. When, for example, in Article 71, it is asserted that common expenditures should be agreed to each year, the words do not quite mean what they seem to imply. German jurists assert that the power of the Reichstag to withhold supplies is limited by the established institutions and principles of the empire. Thus the Reichstag cannot deny those supplies essential to the carrying on of the government. Expenditures are divided into two classes. first, those which can be withheld, or “optional expenditures”; and second, those which cannot be withheld, or “necessary expenditures”. For all supplies of this second class—that is to say, those necessary for the maintenance of the established governmental institutions—the concurrent vote of the Bundesrath is necessary before they can be legally withheld. It thus appears that the popular branch of the legislature has at most a veto power upon expenditures,

and this veto power is limited in its exercise. The German Empire is doubtless a constitutional government, but it is not a popular parliamentary government in the sense in which that phrase is commonly understood, and the budget as a means of exercising control over governmental policies is, in Germany, in a decidedly rudimentary state

(5) *Basis of Budget Right in the United States*—The fundamental law of the United States upon financial matters, as, indeed, upon all others, is found in the constitutions of the Federal Government and of the several States; and it may be said of all these constitutions that it is their aim to secure to the people absolute control over income and expenditure, and in this manner to guarantee to them supreme influence over governmental policies. Omitting from consideration the constitutions of the several States, there may be found in the Federal Constitution four provisions designed to accomplish this end

First In Article I, sec 8, clause 12, it is stated that "no appropriation of money [for the support of armies] shall be for a longer term than two years" In view of the use to which standing armies were put in the eighteenth century, and of the practice, more or less prevalent, of employing mercenaries for the purpose of military service, and, further, in view of the popular jealousy with which a strong central authority was regarded at the time the Constitution was adopted, it is not strange that this provision should have found place in the fundamental law of the land Whether or not this clause would be inserted in the Constitution were that instrument in process of formation to-day is a question respecting which there may be some difference of opinion There are, however, many who, in view of current events, profess, even at the present time, to regard this clause as of paramount importance to the realization of popular government

Second. In Article I, sec. 9, clause 7, it is asserted that "no money shall be drawn from the treasury but in consequence of appropriations made by law," a provision designed to impose responsibility for expenditures upon Congress, and to provide against any encroachment by the executive upon the rights and prerogatives of the people

Third It is further asserted in the same article that a "regular statement and account of the receipts and the expenditures

of all public money shall be published from time to time" In this clause is found the constitutional necessity for a report, which, as already stated, is the first form in which a budget makes its appearance, the demand for which by the representatives of the people was, as a matter of historical record, the first step toward the realization of popular government. It is interesting to notice that the phrase "from time to time" was never interpreted to mean an annual report until 1800, and that so long as the Federalist party was in control of government the question as to the nature of these reports from the Treasury Department to Congress was continually in dispute. In that year, however, largely through the influence of Albert Gallatin, a law was passed which provided for an annual report. By this law the provision of the Constitution referred to was given effect, and its result has been, what was undoubtedly the purpose of the framers of the Constitution, to increase the importance of the legislative body in matters of public policy by giving to it absolute control over all questions of income and expenditure. "The law undoubtedly increased the power of Congress over money matters, and this power was still further increased by the creation of a House Committee of Ways and Means, with well-defined duties and privileges. From this time on the control of the Secretary of the Treasury grew weaker and weaker, until finally the House, through the Committee of Ways and Means, became the sole judge of all kinds of budgetary legislation. Occasionally there was a Secretary who, by superior force of character, so imbued the House with a belief in his ability to manage the finances that his plans were accepted almost without question, but as a general rule the chairman of the Ways and Means Committee had far greater influence than the Secretary of the Treasury in the preparation of financial measures" *

Fourth. The fourth provision of the Constitution which presents itself in seeking for the legal basis of the American budget relates to the origin of revenue bills. In Article I, sec 7, clause 1, it is asserted that "all bills for raising revenues shall originate in the House of Representatives; but the Senate may propose or concur with amendments as on other

* *The Control of the Purse in the United States Government*, by Ephraim D. Adams, Ph.D.

bills." So far as formal expression is concerned, this is an unique feature of the Constitution of the United States and of those constitutions modelled upon it, although the end which it aims to secure is recognised by all peoples who endeavour to realize popular government. The minutes of the convention which framed the Constitution do not indicate that this provision was regarded as of very great importance. "Many considered it the most convenient ground on which to base a compromise, others thought it necessary in order to secure the adoption of the Constitution by the people, while there were a few who were either in favour of it because of a firm belief in the principle or were opposed to it because of an equally firm disbelief in the wisdom of such a provision

"It was, however, of very little importance that the majority of the framers of the Constitution did not regard the restriction of the origination of money bills to the House of Representatives as a great constitutional principle, for the people did regard it as such, and Gerry was right when he said that the presence or absence of such a provision would have much to do with the acceptance of the Constitution by the people. That this provision has come to be regarded as a constitutional principle is clearly shown by the fact that many of the State constitutions which have been either altered or adopted since 1787 contain sections almost, and in many cases exactly, similar to Art. I, sec. 7, of the Constitution of the United States. It cannot be said that the principle of the English Constitution in this matter was accepted by the constitutional convention and therefore placed in our form of government. But once placed there it was accepted by the people as what they were pleased to call "a self-evident truth"; and it has been believed by the American people ever since the adoption of the Constitution that the people, through their representatives, should control the extent and purpose of taxation."

From the above summary it is evident that budgets rest upon the fundamental law of states, and assume an importance in proportion as the people or their representatives consciously aim at control over public policies. The treasury is the heart of the State. "Money is the vital principle of the body politic." He who controls the finances of the State

* Adams' *The Control of the Purse*.

controls the nation's policy. Constitutionalism is the idea, **budgets are the means by which that idea is realized**. Not until the proprietary conception of government shall again attain supremacy, as was the case under the absolutism of the French monarchy, will the question of budgets and budgetary legislation cease to bear a popular as well as a scientific interest.

CHAPTER II.

CONCERNING THE PREPARATION OF THE BUDGET.

BY WHOM SHOULD THE BUDGET BE PREPARED?

- (1) General Considerations.
- (2) Practice in England
- (3) Practice in Germany.
- (4) Practice in the United States.
- (5) Criticism on the American Practice.

WHAT SHOULD BE THE DATE OF THE FISCAL YEAR?

RESPECTING THE RULES FOR MAKING ESTIMATES.

- (1) Practice in the United States.
- (2) Practice in France.

WHAT SHOULD BE THE FORM OF THE BUDGET?

HAVING considered budgets in their relation to popular government, we are now prepared to enter upon an analysis of their form and to undertake a study of the many detailed questions which arise respecting them. There is no room here for original method in treatment. The general order of presentation seems to be fairly well established, and that order will in the main be adhered to in the analysis that follows. It is probable, however, that this analysis may receive a slightly different colouring on account of the fact that all questions of detail will be treated from the point of view of the American Constitution; and, as was pointed out in a previous chapter, this Constitution is peculiar in the care with which the principle of the separation of governmental functions and the balance of governmental powers are worked out.

A budget passes through three stages in its progress to history, the first pertains to its preparation, the second to its legalization, the third to its execution. The present chapter has to do with the preparation of the budget.

22. By Whom should the Budget be Prepared?—The first question that arises in connection with the preparation

of the budget inquires what public officer or department of government should be charged with the duty of making fiscal estimates and financial proposals, and of presenting them as projects of law. We shall first answer this question in a general way, and then state the practice in England, Germany, and the United States.

(1) *General Considerations*—Wherever fundamental law allows the executive to be an active member of the legislative body the preparation of the budget should be the act of the government, that word being used in its strict parliamentary sense. This is true because the government is directly responsible for the fiscal policy of the State, and should be free to control that policy. No other answer is possible in those countries which seek to realize efficiency of administration on the one hand, and the liberty of the subject on the other, through the principle of political responsibility. This will be seen more clearly when we consider the practice in England.

In addition to this general reason for imposing upon the administration the duty of preparing the budget, one or two minor considerations may be mentioned. There is greater likelihood that impracticable theories which look well on paper, but which cannot be realized in practice, will be excluded from the fiscal policy if the administration, whose duty it is to execute the budget, shall have a controlling voice in its formulation. Again, the men who are responsible for the administration of the government are, by virtue of their official positions, better acquainted with the details of financial questions than any other body of men, and on this account it may be presumed that the budget if prepared by them will be well adjusted even in its initial stages. Or, should it be recognised in the course of subsequent discussion upon the budget that it has been carelessly prepared, or prepared in ignorance of the real needs of the State, it lies in the working of responsible government that the body of men thus convicted of carelessness or ignorance should resign in favour of those who have successfully criticised them. This being the case, it may be assumed that the preparation of the budget by the government insures for this work the best talent placed at the disposal of the public.

Yet another reason for placing the preparation of the

budget in the hands of the administration, though it may possibly be regarded as an application of the reasons already given, is found in the fact that under such circumstances there is greater likelihood that an harmonious budget will be eventually voted than would otherwise be the case. Harmony or balance is accepted as one of the most important marks of a well-adjusted budget. The harmony in question is of two sorts. The first pertains to a balance between the estimated and the executed budget, while the second has in view a just apportionment of the aggregate of public expenditures to the various lines of public service. An harmonious budget in this sense of the phrase can only be expected where responsibility for the form in which the budget is voted is direct, personal, and complete. Such considerations as these justify the conclusion that where the fundamental law of the State permits the government to come into parliamentary relations with the legislative body, the budget should not only be prepared by the government, but the government should have control over it at all of its stages.

(2) *Practice in England*—The above considerations reflect fairly well the practice in England. In this country the cabinet, by which the government is administered, is in reality a committee of the House of Commons, and, so far as financial measures are concerned, is held to absolute and unlimited responsibility for all its acts. Though a single body, it acts in many capacities. As executive it draws up and presents to the legislature a report upon the manner in which fiscal laws have been administered in the past, as member of the legislature it presents its financial policy as a project of law which of necessity must reflect the public policy for which it asks grants and supplies; as "the government" it presents to the legislative body, whose support it seeks, such arguments as may be urged in favour of the policy submitted. Nothing could be simpler or more effective than government by a committee responsible to the popular branch of the legislature. It is because of its simplicity, its efficiency, and of the degree of responsibility which it realizes that this organization has received so general a support from students of political science.

The above statements, however, do not give full expression to the degree to which the responsibility of the cabinet in

England in matters of money is carried. The estimates of the fiscal needs must of course come, in the first place, from the heads of the various departments of government, who, in their turn, are obliged to rely upon the detailed knowledge of subordinate officers who have charge of bureaus or divisions. Now, according to English practice, the Chancellor of the Exchequer is given a constitutional control over the estimates of the departments and of the subordinate officials. This does not mean that he is granted a legal right to modify their estimates, but, as the theory of responsibility has worked itself out in England, he does, by virtue of the necessity of defending the budget as a whole before the House of Commons, and of securing support for it from that body, have a controlling voice in determining both the aggregate of grants to be asked, and the apportionment of that aggregate to the several lines of expenditure. This is a characteristic feature of English practice. It is an extreme application of the principle of administrative centralization, and would be incompatible with the idea of political liberty were it not that the power thus centralized is wielded under the restraints of immediate and direct responsibility. There is perhaps no other country where this principle could work as smoothly and successfully as in England; and the fact that it succeeds in England cannot be accepted as proof of its adaptability to other states and other conditions.

(3) *Practice in Germany*—In Germany, and indeed in all countries whose constitutions are of the monarchical rather than of the popular type, practically the same adjustment is arrived at as in England, so far as the form of procedure is concerned, but the results which follow are essentially different. Holding in mind the Imperial Constitution rather than the Constitution of the States, the government, in its double capacity of executive and legislature, is charged with the preparation of the budget as a report, and in connection with the Bundesrath of converting this report into a project of law. It is true that the members of the Reichstag are granted the right of initiative, that is to say the right of proposing finance bills, so that a project of law might, so far as constitutional privilege is concerned, be drawn up and voted independently of the government; but, inasmuch as the Imperial Chancellor is responsible to the sovereign for his ap-

pointment, and can retain his office even though he fail to be supported by the majority of the popular branch of the legislature, and in view of the constitutional principle that the sovereign can alone give authority to law, such a measure would be abortive, except it be accepted by the Imperial Chancellor and made a government measure. It is quite conceivable that as a means of educating the German people to an appreciation of the true nature of their government the Reichstag might be induced to draw out and to vote a budget of its own making. Such a step, however, would be revolutionary, and if successful would result in shifting the centre of real power from the sovereign to the representatives of the people. Thus, while it may be true that the German people follow the same general method in the preparation of the budget as the English, the responsibility for this act, both as regards its nature and its residence, is of an entirely different sort. It need hardly be added that under the German system the government exercises an effective control over the many centres from which the parliamentary estimates are drawn. An harmonious budget, therefore, may be expected in Germany, as in England, so far as that result is dependent on the centralization of authority in its preparation.^{*}

(4) *Practice in the United States*—The peculiar feature of the Federal Constitution of the United States, and of constitutions of the American type, is found in the separation of governmental functions for which it provides. It was believed that the best results would follow should each department of government be independent in the performance of functions assigned to it. As a result of this adjustment no governmental task whatever can be performed without the concurrent acts of these independent repositories of political authority. In England the House of Commons is sovereign; in Germany the centre of government is Imperial authority, in the United States there is no one department which may be called sovereign or the centre of sovereign authority. In view of the separation of governmental authority prescribed by the Constitution of the United States, it follows that the budget cannot be prepared as a complete document either by the executive or the legislative

* This paragraph does not undertake to suggest the relations that exist between the Imperial Chancellor and the Bundesrath.

branch of government. As a report upon the condition of finances, upon the efficiency of fiscal laws, and as the first step in the estimates for the ensuing fiscal period, it is the act of the executive department, as a project of law, however, it must from the nature of the case be an act of the legislative body. Thus the preparation of the budget in the United States may be accepted as a political process different in character from that of either England or Germany; and, inasmuch as a considerable number of constitutions are framed upon the American model, it is as a type and not as an isolated case that its merits and defects must be considered.

It will be of assistance to describe somewhat in detail the process by which the budget comes into existence in the United States. The Constitution requires that "a regular statement and account of the receipts and expenditures of all public moneys shall be made from time to time," and it goes without saying that this must be the work of the official at the head of the Treasury Department. By the law of May 10, 1800, it was provided that this report should be laid before Congress at the beginning of each session, and that it should be a report on the subject of finances "containing estimates of the public revenue and the public expenditure, and plans for improving or increasing the revenue", but it was specifically added in the law that this should be done "for the purpose of giving information to Congress."

From the above statement it is evident that the line of separation between the executive and the legislative function for which provision was made by the framers of the Constitution was regarded as of great importance by subsequent legislators. Were there any doubt of this, ample evidence could be secured from the debates of Congress previous to the law cited respecting the clause which imposes upon the Secretary of the Treasury the duty of including in his report a fiscal "plan." There were those who objected to this when in 1789 the matter was first brought up. "It might be well enough," said one of the members, "to enjoin upon him [the Secretary of the Treasury] the duty of making out and preparing estimates, but to go any further would be a dangerous innovation upon the constitutional privileges of this House; it would create an undue influence within these walls, because

members might be led by the deference commonly paid to men of abilities who give an opinion in a case they have thoroughly studied to support the minister's plan even against their own judgment" * Another member spoke in the course of his argument as follows " Does not the Constitution expressly declare that the House solely shall exercise the power of originating revenue bills ? Now what is meant by reporting plans ? It surely includes the idea of originating money bills, that is, a bill for improving the revenue, or, in other words, of bringing revenue into the treasury For if he is to report plans they ought to be reported in a proper form and complete This is giving an indirect voice in legislative business to an executive officer. . . . But if my construction is true we are giving up the most essential privilege vested in us by the Constitution" †

As against this view it was urged that so long as Congress was free to accept or reject the plan of the Secretary as the basis of the legislative bill no constitutional privilege had been abandoned by imposing upon that officer the duty of submitting a plan. It was this sensible opinion which finally prevailed The debate is significant, however, in that it shows that the difference between the budget as a report and the budget as a project of law was early recognised, and that the statesmen who framed the Constitution were loyal to the principle which rendered such a distinction necessary.

The report of the Secretary of the Treasury is a document of from fifty to an hundred pages It begins with a condensed statement of receipts and expenditures for the year passed, which is commonly followed by a comparative statement showing the decrease or the increase by items during the year Then come an estimate of revenue and an estimate of expenditures for " the present fiscal year " upon the basis of existing laws These estimates, so far as expenditures are concerned, are the totals taken from a detailed and itemized statement of all the branches of the public service, which, as the " Book of Estimates," are submitted to Congress, and which may be regarded as an appendix to the Secretary's report The formal text of the report begins after the results of the estimates are made known, and presents in a condensed form the condition

* Mr. Page Cf *Annals of Congress*, Vol I p 592.

† Mr Gerry. Cf *Annals of Congress*, Vol I. p. 607.

of the various divisions or bureaus or offices of the Department of the Treasury, and calls attention to recommendations or suggestions of subordinate treasury officials for the advantage of their respective services. The report of the treasury officials to the Secretary are commonly bound up with the Secretary's report as appendices, making in the aggregate a volume of from twelve to fifteen hundred pages. These reports are designed to give a complete exhibit of the condition of the treasury and of the views of those who are responsible for its efficient administration.

That portion of the Secretary's comments made in obedience to instructions to submit a "plan" for the consideration of Congress is of course the most interesting and significant. The subjects discussed are as comprehensive and various as the several divisions of the Department of the Treasury,¹ and go far beyond the strict limits of budgetary considerations. Currency, banking, the mint, the independent treasuries, the rules for collecting revenue, and many other kindred topics are subjected to discussion according to the exigencies of the service or the needs of government. There is no public document regularly published which reflects so clearly the current history of the nation as the annual report of the Secretary of the Treasury. On one occasion at least it gives rise to the suspicion of having been written with the purpose of influencing the nation's foreign policy.[†]

But notwithstanding the great importance of this report and of the influence frequently exerted by means of it, the report itself does not pass beyond the first stage of the formal budget. It is a report for the instruction of the legislative body, nothing more. The fact that it is presented in the form of a "plan" and is commonly expressed in the language of a government policy does not change in the least its real character. The "plan" is not recognised by the Constitution as a governmental policy, and cannot become such a policy by any act of the executive. It is not too much to say that the Secretary of the Treasury can exercise no constitutional influence upon fiscal legislation. He has no right to appear upon the floor of the House of Representatives in

* For statement of the organization of the Treasury Department see § 34.

† Gallatin's report of 1807.

order to explain or urge his plan, and his appearance in any of the committees of either the House or the Senate is a courtesy, and not a constitutional right. In the United States the budget as a report is absolutely severed from the budget as a project of law. The preparation of the former pertains to the executive, that of the latter to the legislative, department of government.

The report of the Secretary of the Treasury, together with the Book of Estimates, having been submitted to the Speaker of the House of Representatives, it is referred by the Speaker to the appropriate committees, and from this point on until an approved bill is submitted to the President for his signature the constitutional control over financial legislation lies entirely in the hands of Congress.

A word may be necessary respecting the committee system in order to explain the preparation of those financial bills which taken together constitute the budget in its second stage. The most important of these committees is that on Ways and Means, which in 1795 was made a standing committee to hold during the session of the Congress by which it was appointed, and in 1802 was given a permanent place in the parliamentary organization of the House of Representatives. As constituted in 1802 the Committee of Ways and Means was charged with two distinct and comprehensive lines of duty. In the first place it was "to take into consideration all such reports of the Treasury Department, and all such propositions relative to the revenue, as may be referred to them by the House; . . . to inquire into the state of the public debt, of the revenue, and of the expenditures, and to report from time to time their opinion thereon." In the second place it was stated that "it shall be the duty of this committee . . . to examine into the state of the several public departments, and particularly into the laws making appropriations of money, and to report whether the moneys have been disbursed conformably to such laws, and also to report from time to time such provisions and arrangements as may be necessary to add to the economy of the departments and accountability of their officers."

It is the first of these lines of duties with which this study is at present especially concerned, that is to say, the task of raising public revenue and of localizing its expenditures. It

is significant that the resolution does not call for a report from the Committee of Ways and Means in the form of a bill, but states explicitly that the report shall be a "report of opinion." This doubtless reflects the jealousy with which the House regarded any possible curtailment of its authority. At the present time, however, it is the universal practice of this committee, as also of other finance committees, to report in the form of bills. According to accepted practice the Committee of Ways and Means has almost exclusive control over that side of the budget which has to do with the raising of revenue. Its preparation is under the control of the committee, and, as a rule, the work is performed in the committee.

Without passing to call attention to the several experiments which were tried from time to time, it is pertinent to notice that in 1865 the duties assigned to the Committee of Ways and Means were modified in a marked degree by the creation of a Committee on Appropriations. The mover of the amendment by which this committee was created explained that it was designed to divide the work of preparing finance bills between two committees, and in this way to secure greater care and greater economy in the management of the government finances. The duties of this new committee as presented in paragraphs 76 and 77 of the Rules of the House are as follows.*

Rule 76: "It shall be the duty of the Committee on Appropriations to take into consideration all executive communications and such other propositions in regard to carrying on the several departments of government as may be presented and referred to them by the House." Rule 77: "It shall also be the duty of the Committee on Appropriations within thirty days after their appointment at every session of Congress, commencing on the first Monday of December, to report the general appropriation bills for legislative, executive, and judicial expenses; for sundry civil expenses; for consular and diplomatic expenses; for the army; for the navy; for the expenses of the Indian Department; for the payment of invalid and other pensions; for the support of the Military Academy; for fortifications; for the service of

* Rules of Order of 37th Cong., House Journal, 1862-63, 3d Sess., Appendix, p. 632. Also Cong. Globe, 2d. Sess., 38th Cong. pp. 666, 1311-1317.

the Post-Office Department and for mail transportation by ocean steamers; and in failure thereof the reasons for such failure. And said committee shall have leave to report such bills at any time."

It will be noted that among the duties of this committee is that of rendering its report on appropriations in the form of bills, which from the constitutional point of view makes the committee of a decidedly different character from the old committees, which were to report "opinions." It shows that the House of Representatives had abandoned the attempt to "originate" money bills, as that phrase was understood in 1789, and that American practice had moved in the direction of committee responsibility as the solution of the problems of parliamentary procedure imposed upon this country by the separation of governmental powers.

A third committee should be noted in this connection. In 1883 the Committee on Rivers and Harbours was created to study and prepare such bills as pertain to appropriation of moneys for the improvement of rivers and harbours. Two years later this tendency was carried yet further. It happened in that year that the gentleman who had for several years been chairman of the Committee of Ways and Means was at variance with the leaders of his party, and with the administration, upon the subject of the tariff. For certain political reasons, however, it seemed wise for the Speaker of the House to continue him in the chairmanship of that committee. It will be remembered that appropriation bills take precedence of other legislation, being bills of the highest privilege, and the chairman of the Committee on Appropriations did not hesitate to use his power to obstruct any legislation not approved by him. At the beginning of the Forty-ninth Congress it was determined by the Speaker to take from the jurisdiction of the Committee on Appropriations the majority of the appropriation bills, and after a sharp contest this was done. Thus the bill for the support of the diplomatic service was given to the Committee on Foreign Affairs, the bill for the support of the military establishment was given to the Committee on Military Affairs, the bill for the support of the naval establishment was given to the Committee on Naval Affairs, the bill for the support of the Indian service was given to the Committee on Indian Affairs, and the bill for the support of

post-offices and post-roads was given to the Committee on Post-offices and Post-roads. This left to the Committee on Appropriations only the executive, the administrative, the judicial, the pension, the District of Columbia, the deficiency, and the permanent appropriation bills. The practice thus established has been maintained to the present time. It thus becomes evident that the tendency in this country is towards the dispersion of responsibility for financial legislation, rather than towards the concentration of responsibility in the hands of a single committee.

Going back now to the main question from which this inquiry started, it appears that the preparation of the budget in the United States is begun by the executive department of government. The communication from the executive department may be in the form of a note from the President as well as a report from the Secretary of the Treasury. Only under unusual conditions would other members of the cabinet venture to submit recommendations embracing estimates of expenditures, although, as will shortly be explained, officials of minor offices do make personal appeals to the members of the various appropriation committees for modifications of the Secretary's recommendations. The budget as it leaves the hands of the executive is submitted in the form of (1) a report upon the execution of existing fiscal laws for the past fiscal period; (2) an estimate of the fiscal needs of government for the period about to be entered upon; (3) an outline of the policy upon fiscal affairs which may be accepted as an expression of the desire of the administration. This document, or documents, being accepted by the Speaker of the House of Representatives, is referred to the several committees concerned, to be used by these committees in such manner as they shall see fit. According to the usual practice the report and the estimates of the Secretary of the Treasury are made the basis of fiscal legislation, but there is no legal or constitutional requirement to this end.

The preparation of the budget in its second stage is wholly a legislative act, and in this country is performed by the appropriate committees. These committees may adopt the executive recommendation as the basis of their bills, in which case they convert the advice of the executive into a legally expressed governmental policy for the consideration of the

legislature; or they may ignore the recommendations of the administration and prepare bills according to their own liking

(5) *Criticisms upon the American Practice*—The evils which arise in connection with the American method of preparing money bills are three and as follows

First The treasury official, who is nominally responsible for the estimates submitted to Congress, is given no constitutional or legal authority to control them. His duty is largely clerical. Accepting the estimates of the heads of the various independent departments and bureaus of the government, he causes them to be classified and summarized, and transmits the result as the Book of Estimates*. He feels no official responsibility for the amounts which it contains, nor is there any guarantee in the manner in which the estimates are brought together that they reflect the fiscal needs of the government economically administered, or that a just balance is maintained between the appropriations to the various branches of the public service, as would be the case were the Book of Estimates recognised as the basis of all legislation upon appropriations. As an individual or as a member of the cabinet, and through cabinet courtesy, he may doubtless influence somewhat the estimates of the various departments. In his capacity of auditor also he may call attention to the necessity of greater economy in certain departments than the officials in charge have seen fit to recommend; but inasmuch as the authoritative opinion on expenditures as presented to the legislature is that of the Committee on Appropriations and other committees rather than of the Treasury Department, the Secretary feels no imperative necessity of presenting the estimates in the shape in which, according to the administrative policy, they ought to become law†. This must be recognised

* "The estimates of this department are submitted as made up by the officers in charge of the public duties to which they respectively pertain, and while exceeding those of last year by the sum of \$1,699,332 69, they are in excess of the appropriations made for the department at the last session of Congress only to the extent of \$608 55." From the 1881 Report of the Secretary of the Treasury, p. vii

† The Secretary of the Treasury cannot be constitutionally the possessor of that "ferocity" which, according to M. Thiers, is essential for a successful Minister of Finance. The following is quoted by Stourm as indicating the quality or character that must be displayed by one intrusted with the administration of public expenses. After

as a serious defect, and one which will inevitably lead to serious evils. Each department, freed from all control, freed also from that sense of responsibility which comes with the contemplation of the ways and means to meet expenditures, and incited by the desire to increase its relative importance in the government by increasing the money voted for its support, will estimate its needs in a very lavish manner. The aggregate of expenditures asked for will, under such conditions, be greater than under a system which recognises the estimate of the administration as the final and authoritative estimate. If to this be added that the Committee on Appropriations, when it undertakes an analysis of the estimates, consults with the heads of the various departments and bureaus, and even with sub-officials of the departments and bureaus, rather than with the Secretary of the Treasury as the representative of the administration in matters of expenditure, it is easy to see how inter-departmental emulation and private interests will tend to swell the aggregate of expenditures. There is thus disclosed a most serious defect in the American system of preparing money bills. This defect might in part be removed should the Committee on Appropriations recognise the Secretary of the Treasury as the only means of financial communication between itself and the administration. Such a ruling would be a reform in the direction of concentration of responsibility, and as such would be in perfect harmony with the theory of an effective popular government. This proposal will be further considered when the question of reform is taken up for discussion.

Second. The second difficulty in the attainment of good results under the American practice is due to the separation of responsibility in the preparation of the budget in the legislative body itself. The Committee of Ways and Means has praised M. Mange for "sweet temper and rare good sense, qualities of great importance for one who administers public finances," M. Thiers continues his address as follows: "To this praise, if you permit me, I desire to add a slight reproach ['Ah! ah!'], but very slight. I shall not reproach M. Mange for the lack of any good quality, no! I shall reproach him for the lack of a certain fault. This fault (I search for a word to characterize it; I am obliged to employ one a little strong, but you will pardon me), this fault which M. Mange lacks is a *certain ferocity* which I regard as indispensable to a Minister of Finance." Cf. Stourm, *Le Budget*, p. 63.

to do with raising revenue, the Committee on Appropriations has to do with expenditures. These are independent committees of equal and coordinate authority. Were they both obliged by custom, rule, or law to consult with the head of the Treasury Department relatively little harm would arise from the fact of their independence, but as it is there is no guarantee of harmony between income and expenditure. On the other hand there is every reason to expect a discrepancy between the two sides of the budget. It is true, as was asserted at the time the Committee on Appropriations was created, that this committee may consult with the Committee on Ways and Means, but the liberty to consult is essentially different as a principle in parliamentary organization from the legal necessity of consultation or the legal authority to control. Neither committee is obliged to adjust its discussion to the policy of the other.

It may be said as against this criticism that the Committee on Appropriations has existed since 1865, and that no serious complaints have been heard respecting its action, but it should be remembered that during the thirty years of its life the Federal Treasury has been in constant possession of surplus funds. How the difficulties arising from the separation of authority will be adjusted when the task imposed on the Committee of Ways and Means is that of augmenting the revenue rather than reducing it is a question upon which the experience of the United States has as yet thrown no light. The separation of the committee on expenditures from the committee on income, and the removal of both committees from any constitutional influence or legal control of the executive department, leads to an unwarranted looseness in all matters of fiscal legislation. In this lies the weakness of the American budgetary system, and if, with the separation of legislative responsibility above referred to, it is recognised that the Committee on Appropriations is such in name only, owing to the fact that many of the important committees can bring in bills for the expenditure of public moneys, one begins to appreciate the extent to which responsibility for fiscal legislation in the United States is diffused by the established practice of Congress.

Third. The third defect in the method of preparing the budget as presented in the United States is due to the fact

that the authority of the President cannot be brought to bear upon fiscal legislation during its initial stage. Such legislative authority as he possesses rests upon his right to veto bills presented for his approval, and this cannot be exercised until the bills have passed both Houses of Congress. The practical result of this is that the President has no voice in the adjustment of the details of finance bills, and this is equivalent to saying that his opinions are of slight importance in questions of income and of expenditure.

It was undoubtedly the intention of the framers of the Constitution that this should be the case, but it is at least open to question whether or not they adequately appreciated the incongruity of the situation. They did not foresee the rise and influence of standing committees. The President is the only officer elected by the people of the entire country. He is the only person who by virtue of his election may be said to represent the popular will. The committees, whose powers, as will shortly be pointed out, are almost absolute in the framing of laws, are composed of men who represent congressional districts. Is it not an incongruity that in a matter of such vital importance to the entire nation as the laws for raising and disbursing revenue the men who, by virtue of their position, are the most influential are responsible not to the country at large, but to a small district of a possibly small State? It is a matter of serious complaint that the will of the people as expressed in presidential elections is so tardily reflected in current legislation, and this in large measure is due to the inability of the representative of the people to influence in an official manner the details of bills while yet they are in their formative or plastic state. Nowhere does this evil present itself more clearly than in connection with financial legislation.

23. What should be the Date of the Fiscal Year?—Another series of questions brings into view the time element of the budget. What should be the length of the fiscal period? What date should be chosen for the beginning of that period? At what time in the legislative session should the budget be presented?

So far as the length of the fiscal period is concerned, the practice seems to be quite uniform. The year—that is to say, a period of twelve months' duration—is accepted as the most

convenient period contemplated by fiscal legislation and fiscal administration. This does not mean that for some purposes the year may not be broken into fractional parts, or that for other purposes it may not be used as the submultiple of a longer period. In the great majority of cases, however, the unit of time is the year, and the phrase "fiscal year" is a familiar one in financial discussion. This is but a recognition of the universal practice, the reasons of which are too manifest to require statement.

With regard to the date at which the fiscal year begins there is not the same uniformity in practice. Thus in France the fiscal year is the calendar year. It begins with January 1st and ends with December 31st. Formerly this was the commonly accepted fiscal period, but at the present time the majority of nations have selected other dates. After several experiments England, in 1855, adopted April 1st as the beginning of her fiscal year, a precedent which has been followed by the German Empire, by Prussia, Wurtemberg, Denmark, and Roumania, as also by other states. The United States used the calendar year as her fiscal year until 1844, when a change was made to July 1st. This date was adopted after a somewhat extended discussion as to the relative merits of several proposed periods. Other states which accept July 1st as the beginning of the fiscal year are Spain, Portugal, Norway, Canada, and Mexico. In Belgium the fiscal year, as in France, coincides with the calendar year, but in order to overcome the difficulties incident to this practice, and which, indeed, induced other nations to adopt April 1st or July 1st as the beginning of the fiscal period, Belgium has found it necessary to break the fiscal year for certain purposes into months, and to recognise *le douzième provisoire* as a necessary adjustment in her budgetary system. The choice of the fiscal period, then, does not seem to be entirely an arbitrary matter; on the contrary, it is a detail of considerable importance.

The considerations by which the date for the beginning of the fiscal year is chosen are the same, in a general way, as those which determine the time at which the budget should be presented to the legislative body. It is of course desirable that the estimates, whether of income or of expenditure, should be as accurate as possible. The budget as estimated

should harmonize with the budget as executed. In order, however, to secure this balance between estimated and actual expenditure and income it is of importance that the votes which provide for revenue and legalize expenditure should be taken as short a time as possible before the date at which fiscal laws are to go into operation. There is no way of accomplishing this except to place the date for the beginning of the fiscal period as short a time as possible after the date when, in ordinary parliamentary practice, the final vote on fiscal bills will be taken. Thus the beginning of the fiscal year should, in a general way, coincide with the end of the parliamentary year.

The importance of allowing as short a time as possible to intervene between the date of the vote upon the budget and the date of its going into operation will be appreciated if the source of discrepancies receives a moment's consideration. It is possible for estimates to err either on the side of income or of expenditure. Revenue from some sources may be accurately calculated. Thus revenue from a land tax or a poll tax may be accurately determined. Revenue which is likely to accrue from an income tax, also, provided it be of long standing in a community, may be estimated with confidence. Yet even here any considerable change in the rate will so modify the inducements to concealment and false statement as to invalidate somewhat the trustworthiness of the estimate. When, on the other hand, the financier is called upon to estimate the probable proceeds of indirect taxes, such as excise duties or duties on imports, he encounters a number of variable factors. Such taxes are paid by the consumers of taxed commodities, and their proceeds consequently fluctuate with the consuming ability of the community. Now this is a variable factor, and one which cannot be determined with any certainty for any considerable length of time before the date at which the estimate is made. It is essential, therefore, in order to venture a fair guess respecting income, that the guess should be made at a time when the probable industrial condition of the country can be foretold with some degree of accuracy. This is the reason why the final estimate—that is to say, the vote of the legislative body on fiscal matters—should be placed as closely as possible to the beginning of the fiscal year.

Expenditures are perhaps capable of greater accuracy of estimate than income, since they are, in a measure, a matter of

choice with the government. Thus the expenses of the army or of the navy in time of peace will probably be about the same from year to year. This is also true of the civil list, while payments to the sinking fund and other contractual payments are capable of exact calculation. It is, however, impossible to estimate accurately the expenses of the foreign service, of the judiciary, or indeed of the amount which must be expended any particular year for public works. But it is true of expenditures as of income, that the less time intervening between the estimated and executed budget the greater is the likelihood of harmony and of balance.

A study of the practice among various states bears testimony to the truth of these considerations. In England, whose financial administration is equal to that of any other country, the time intervening between the first presentation of the budget and the date of its going into operation seldom exceeds five months. The circulars calling for estimates from the various departments of state are sent out toward the end of October, and are presented to the House of Commons some time in February. Thus both the estimates and the vote are brought close to the date of execution. In the United States the report of the Secretary of the Treasury must be presented to Congress within ten days after the beginning of each session of Congress, while the committees on Ways and Means and on Appropriations are required to report to the House within thirty days from the time the estimates are submitted to them. Thus from six to seven months may be said to intervene between the first estimates and the beginning of the fiscal year to which these estimates apply. When, however, it is recognised that the estimates of the Treasury Department are not authoritative, but that these may be and commonly are revised by the committees, it follows that the period between the estimated budget and the beginning of its execution is much shorter.

The practice in France does not commend itself to one educated in the stricter schools of English or American financing, since fourteen or fifteen months frequently intervene between the estimates of income and expenditure and the time when the laws based upon those estimates go into operation. For example, the administration will begin its estimates for the year 1897 in October or November of the year 1895.

Under such conditions accurate estimates cannot be expected, since it is impossible for any one to tell so long beforehand what the commercial condition of the country will be. It is not, therefore, surprising that the estimates in France should exert little influence upon financial legislation. Nor is it surprising to learn that France, of all countries in Europe, does not find it inconvenient to retain January 1st as the date beginning its fiscal year.

The conclusion of this analysis is that April 1st or July 1st is the best date for the beginning of the fiscal year, since in this manner the least possible time intervenes between the legalization of income and expenditure and the opening of the period to which the laws apply.

24. Respecting the Rules for Making Estimates. — The first step in the formation of the budget consists in making estimates of the income and expenditures for the year to be covered by the fiscal legislation of the budget in question. The importance of sound estimates arises from the fact that at no time in its brief history is the budget in so plastic a condition as during its initial stage, at no time can it be brought so easily to reflect the policy of the government or the interests of the public. Should the budget go far astray in the matter of estimates it would be very difficult, if indeed possible, to bring it into shape during its progress through the legislature, for that body cannot be brought to show an equal interest in all chapters of so comprehensive a scheme of legislation, a fact due in part to the large numbers that compose it, and in part to the local character of the representation which its members sustain. Sound fiscal legislation must begin with a conservative estimate of probable receipts, and a purposeful estimate of probable expenditures.

As Stourm very pertinently remarks, the qualities necessary for correct estimates are sagacity and integrity — sagacity to see clearly into the future, integrity to declare with truth what one sees*. It is of course impossible to cultivate these qualities, or to secure them at will for the service of the State in case they exist. The most that can be done by the Science of Finance is to inquire respecting the various methods adopted for arriving at correct estimates, and to derive from

* Stourm, *Le Budget*, p. 156.

ber, and is, on this account, in a position to modify the estimates he is called upon to make by the appearance of any unusual disturbance in the orderly course of receipts or expenditures. Under such conditions it ought not to be difficult to forecast with considerable accuracy the estimates for the remainder of the current year, since, as a matter of fact, the government has before it the actual receipts and expenditures for five out of twelve months of the period under consideration.

We have not, however, come to the most difficult task imposed upon the Secretary of the Treasury. The important estimate contained in his report pertains to the fiscal year following the current year in which his report is submitted to Congress; that is to say, his report for the year ending June 30, 1896, must contain a statement of actual and estimated receipts for the year ending June 30, 1897, and an estimate of income and expenditures which may be used as a basis of fiscal legislation for the year ending June 30, 1898. The practice usually adopted is to calculate what would be the probable receipts of the government on the assumption that existing laws should be continued, and then to modify this estimate on the basis of proposed changes in the laws or in the services to be undertaken. It is evident that the variable element in such a calculation, and the one which calls for sagacity and intelligence, arises from the instability of business and commercial conditions. The movements in population affecting the general consumption of a nation may be forecast with a fair degree of accuracy. Beyond this, however, there is no assured stability in the conditions which determine the productivity of taxes. A depression in business prosperity will tend to increase the revenue to the State, while unusual prosperity will tend to increase that revenue. The strength of the perturbing forces cannot be measured in any arbitrary manner, although the Secretary, in arriving at his estimates, is obliged to assign a definite influence to each of these forces and to make allowance accordingly.

The accuracy with which governmental receipts may be estimated for a period which lies in the future depends upon the ability of the Minister of Finance to forecast the commercial and industrial life of the period. There is perhaps no other task in connection with the administration of finance that calls

for so comprehensive a knowledge of industrial forces, or so minute an acquaintance with statistical data * The accumulated experiences of successive years will undoubtedly result in the formulation of certain rules that will prove to be of great assistance in making estimates, but these rules should always be used with intelligence and discretion. Such are the considerations urged in support of the theory so generally accepted that the only guarantee of satisfactory estimates consists in establishing those conditions that invite the exercise of sagacity This is done by bringing the date of estimate as near as possible to the period for which the estimate is made, since in this manner not only is the task rendered relatively easy, but the results of a slovenly estimate will quickly appear as a censure to him responsible for it

(2) *Practice in France*—As a contrast to the general method of procedure followed by the larger number of modern nations, the practice in France bears a peculiar interest It must be held in mind that the period intervening between the time for which the budget is estimated and the period to which it applies is much longer in France than in other countries, and that a careful calculation of probable receipts is on this account rendered more difficult The broad margin of time between the estimated and executed budget invites a play of the imagination not permitted, at least to so great a degree, under the conditions adopted by other peoples Such being the situation, it is perhaps natural that France should have adopted an arbitrary rule for arriving at probable receipts

Since the time of the Restoration it has been the accepted practice to report in place of an estimate the covered receipts of the last preceding year To make clear what is meant the following is quoted from the speech of M. Sadi-Carnot, who was Minister of Finance in 1886 He says: "The direct taxes have been calculated according to the old method, which consists in taking for the basis of the future period the receipts realized during the last period for which the accounts are complete" ("c'est-à-dire, les recettes de l'année antépénultième") † Such a process cannot, of course, result in presenting to the

* It is on this account that a well-equipped statistical bureau is essential to the equipment of the Treasury Department.

† Quoted from Stourm, *Le Budget*, p. 158.

legislature an accurate statement of probable results which can be used as a basis of fiscal legislation, and its inevitable tendency must be to invite the legislature, in making appropriations, to disregard the estimate of receipts submitted in the budget. It would be difficult to conceive of a more pernicious tendency in financial legislation than to proceed in the voting of appropriations or in the revision of revenue laws without a clear appreciation of the receipts which existing laws would be likely to secure.

This embarrassment has been frankly recognised by the publicists of France, and there have been two suggestions designed to remedy this defect. The old rule for estimates having been interrupted by the revolution of 1848 and subsequent events, the question of the proper method of procedure was formally considered in 1854. Speaking of this question the chairman of the Budgetary Commission expressed himself as follows: "The old method of procedure has certain advantages which we do not overlook, but it has the inconvenience of contributing to receipts an estimate always inferior to their reality, and of necessitating also an estimate of expenses upon a scale which is generally known to be below their reality. From this there arises the grave inconsistency of having by the side of the avowed budget a budget held in reserve"*. To remedy this defect it was proposed to substitute the *système des majorations*, which means in effect that to the covered receipts of the antepenultimate year should be added an estimate of the increase in receipts for the year to which the budget applies on account of the expansion of commerce and trade, or for any other cause known to the Minister. This plan, however, was not followed for any considerable length of time; and when the confusion occasioned by the Crimean, the Italian, and the Mexican wars had passed, and the question of orderly estimate was again considered, the old rule was brought forward and formally accepted. This was in 1863. In 1882 the question was again discussed, and it was proposed by M. Léon Say to revive the practice of estimates, although in a somewhat modified form. His proposal was to accept the average receipts of the five years previous to the date of estimate as the basis of calculation, and to modify the result thus obtained by general considerations which would suggest

* Quoted from Stourm, *Le Budget*, p. 160.

themselves in attempting to forecast the operations of laws in the future. It would have been interesting to observe what might have been the result of this plan, but unfortunately it was followed for a year only. It is not likely, however, that the practice would have exerted any marked influence upon the financier. The difficulties in the French system are radical. The period intervening between known results and the date for estimate is too long, while the accounts of the treasury are so tardily closed that the data for estimates would in any case be comparatively old. The system invites neither careful estimates nor careful legislation. The practice of other peoples is rather to be commended.

25 What should be the Form of the Budget Statement?—

The third of the technical questions respecting the preparation of the budget pertains to the form in which it shall be presented to the legislature. Upon this point it may be said, in the first place, that whatever its form it should be the same from year to year, or at least that no arbitrary or unnecessary changes should be introduced. The reason for this may be easily stated. The rules and customs concerning the passage of money bills should be so firmly established and so well known that no member of the law-making body can plead ignorance, either of the condition of the bill at the time his vote is requested or of the parliamentary effect of his vote, as an excuse for an erroneous decision. An established rule respecting the form and classification of estimates cannot, of course, enable a legislator to avoid error of judgment respecting the general policy embraced in a proposed law, but it may enable him to understand what is implied by any particular vote on any particular chapter of the budget at any particular stage of its progress. An illustration will make this clear:

Suppose that for a series of years the customary appropriations for United States marshals has been included in that of the judiciary, and that without proper notification it is changed to some other chapter of the budget. Under such circumstances it would not be strange should some member of the legislature cast his vote for the judiciary appropriation, assuming that by so doing he had made the customary provision for the marshals. It is futile to suppose that every member of the legislature can keep himself informed respecting the details of all bills that claim his suffrage at all their stages of progress.

towards law. He performs his full duty (except for such bills as he may introduce or as come from the committee of which he is a member) if he keeps himself in touch with the general legislative principles and governmental policies involved in the great mass of bills, and he is justified in assuming that, in the absence of formal notification to the contrary, the rules of procedure, the classification of items, the terminology employed, and the like, of regularly recurring bills, will continue the same from year to year. Permanency in the adopted form of a budget is, perhaps, of more importance than the particular form adopted.

That the budget should be introduced as a comprehensive document will doubtless be conceded. This is true because the general condition of a nation's finances must be known before a rational opinion upon any particular proposal respecting either income or expenditure can be entertained. It is necessary, therefore, that a budget statement should begin by an exhibit on a single page of the aggregate of actual receipts and expenditures for the year past, the aggregate of receipts and expenditures, actual and estimated, of the year current, and the aggregate of estimated receipts and expenditures for the year for which laws are to be enacted. This is the general practice of nations, and in this regard the annual report of the Secretary of the Treasury may be accepted as a model of concise and comprehensive statements.

To say that the budget statement should be comprehensive does not, however, answer all the questions that arise respecting its form, for the query still remains respecting the classification of income and expenditure most conducive to clearness of discussion and intelligent legislation. The budget will probably be voted in substantially the form in which it is presented; such, indeed, is the common practice of nations, whatever their political or parliamentary organization. The form that the budget should assume cannot be determined by reference to any one consideration. The question which it presents is partly a question of administrative organization, partly a question of convenience for legislative study, and partly a question that calls for compromise between the financial and the political interests involved. The consideration last mentioned is the only one that calls for comment.

The natural demand of the financial interest is that the

budget should be clear, simple, easily understood, and of few classifications. About all that the rank and file of the legislative body is called upon to consider is the aggregate of expenditures, and the apportionment of this aggregate to the several lines of public service; for, so far as income is concerned, it can hardly be expected that the individual members of the legislative body will proceed in their analysis of financial affairs beyond a study of the general principles underlying the project of the law. It is of course necessary that estimates should rest on a careful scrutiny of details, but, as we have already seen, this task is either performed by the government or is intrusted to a specially appointed committee. All this detail must be taken for granted by most of those whose votes legalize income and expenditure. This being the case, it is not necessary that any considerable amount of detail should be included in the budget in the form in which it is presented to the legislative body for general discussion and approval.

A further consideration against too great detail presents itself in case expenditures are voted by chapters and each chapter voted independently, for under such conditions there is great danger that the aggregate of expenditures will not be properly apportioned to the several services calling for support. This is primarily a question of how the budget shall be voted, rather than how it shall be presented; but, as leading to a just balance between the items, or clauses of items, which make up the aggregate of appropriations, the financial interest seems to require that the budget should come before the legislative body in the form of a few comprehensive classifications.

The constitutional interest, which, in the opinion of some writers, demands a compromise with the financial interest, presents the following claim. The budget, it is asserted, is the principal means by which the administration is held in check and the general policy of the government controlled. The classifications should not, therefore, be so comprehensive as to render difficult a test vote upon any question of public policy likely to arise in connection with appropriations. The administrative classification approved by the financial interest is too comprehensive for this purpose. On the other hand, that which by contrast may be termed the legislative classification would be so minute as to destroy the sense of completeness which should result from the first reading of a

budgetary statement No general conclusion can be laid down for bringing these two conflicting interests into harmony. Each nation must decide for itself what is wise, resting its decision upon the degree to which the constitutional principle has been developed, and the extent to which other means have been established by which the constitutional influence of the legislature can be made effective as against the executive. This much of a generalization, however, may be ventured if confined in its application to American conditions Good government in this country at the present time is placed in jeopardy rather by loose methods of business procedure than by an undue extension of administrative influence The important problem in the United States at the present time pertains to the control of the legislature by the people, and not to the control of the executive by the legislature. The financial interest, therefore, is relatively of more importance than the constitutional interest, and should be granted a greater influence in giving form to the budgetary statement. Some progress toward the recognition of sound business principles in financial legislation may be expected from clearness, simplicity, and permanency in the budget as presented to the legislative body The question thus brought to notice will receive further attention in connection with the passage of the budget to its vote.

It appears, then, that the basis of an acceptable classification for the budget statement is found in the organization of the government for the purpose of administration The Book of Estimates should be compiled so as to reflect the departments, bureaus, or offices into which the government is divided. The classification of receipts, also, should be adjusted to the source from which those receipts are drawn Such a classification would, in the main, meet the convenience of the legislature for the purpose of study and of the administration for the purpose of estimate. Another strong consideration in its support is that it is the only classification which will be likely to continue for any considerable length of time Our general conclusion, then, respecting the form in which the budget should be presented is that it should be drawn conformable to the administrative divisions of the government, but that these great divisions may with propriety be divided into appropriate chapters, which in their turn reflect the organization within the departments themselves.

CHAPTER III.

ON THE PASSAGE OF THE BUDGET TO ITS VOTE.

ORGANIZATION OF THE LEGISLATURE FOR STUDY OF THE BUDGET.

- (1) Practice in England.
- (2) Practice in France.
- (3) Practice in the United States.

SHOULD ALL MONEYS BE VOTED ANNUALLY?

- (1) Several Considerations.
- (2) Practice in England
- (3) Practice in France
- (4) Practice in the United States.
- (5) Practice in Germany.
- (6) Conclusion

IN WHAT FORM SHOULD THE BUDGET BE VOTED?

REFORM OF THE AMERICAN BUDGETARY SYSTEM. ,

- (1) Enumeration of the Defects.
- (2) Consideration of Remedies

MOST writers on finance draw clearly a line between the preparation of a budget and the passage of a budget to its vote. In all countries where cabinet government prevails, or where the ministry is responsible to the monarch, and consequently independent of the legislature, the preparation of the budget is a process distinct in fact as well as in theory from its legalization. Only in countries where there is a constitutional separation between the executive and the legislative departments, and where all bills of all sorts take their origin in the legislature, is it difficult to maintain this distinction at every point. The present treatment of the subject has, however, endeavoured to conform to the usual course of analysis, and, as an aid to this end, has everywhere treated of the budget first as a report, and second as a project of law. That which claims the attention of the present chapter is the budget as a project of law, no matter by what means it passed

from the first to the second stage of its development. The question to be discussed pertains to the most appropriate rules, parliamentary as well as constitutional, by which a project of law becomes an authorized bill for the raising or the expending of public funds.

26. Organization of the Legislature for Study of the Budget.—The first question which presents itself in this connection pertains to the organization of the legislative body for the study of a fiscal policy presented for its approval. In all countries of any size this organization takes place under some form of the committee system. In England the committees in question are the House organized as committees of the whole. In France provision is made for committees of investigation by the rules of the Chambers. In the United States standing committees have come to be a recognised part of parliamentary machinery. All the essential principles respecting the organization of parliamentary bodies for the purpose of studying a financial policy will present themselves in connection with an analysis of the practice of these three countries.

(1) *Practice in England*—The initiative of all business in England is the throne speech and the address in reply. This speech is a part of the ceremonial remaining from the time when the monarch was in fact as well as in theory the centre of political power. It contains an estimate of the fiscal needs of government, and the first vote taken is that a supply be granted. This is neither amendable nor debatable except on the day agreed to. The vote is significant because it is a guarantee that the ordinary operations of government will not be jeopardized by political controversies*. The formal vote of supply being passed, however, the House, by a second vote, appoints a day on which to resolve itself into a committee to consider the supply granted, or, as it is commonly called, a Committee of Supply. It is in this committee that the legislative study of the budget, as distinct from the executive study which has been previously given to it, takes place. The appropriations having been decided, so far at least as to deter-

* The interpreters of the Imperial Constitution of Germany aim at the same thing when they say that the Reichstag is not at liberty to withhold appropriations essential to the maintenance of established institutions. Cf. § 21, (4).

mine in a general way the aggregate of expenditures, the House resolves itself into a committee to consider the ways and means of raising the money granted. This committee is called the Committee of Ways and Means. It is in connection with the session of this committee that the Chancellor of the Exchequer delivers his "budget speech."

The organization of Parliament for the study of finance bills centres in the character of the two committees referred to, namely, the Committee of Supply and the Committee of Ways and Means. They are neither standing committees nor special committees. They are the House of Commons convened under the free and easy rules of a committee rather than under the stricter rules of a parliamentary body.

Nothing could be farther removed from an ideal adjustment. The scrutiny of the budget ought to be committed to a small body of picked men who, by virtue of their experience and ability, understand the needs of the country and the principles of finance. The procedure ought to be such as to invite study and avoid oratory, and it would certainly seem that the organization of the House into a committee freed from the stricter rules of parliamentary practice would prevent fruitful discussion and conservative deliberation. It is therefore something of a surprise to learn that the plan works well, but the fact that it works well must not be accepted as commendation of the plan. The success of this manner of studying the budget testifies to the natural aptitude of the English for self-government, it does not prove that it can be followed with success by other peoples.

It will add something to our knowledge of the subject if we inquire why this loose method of procedure succeeds so well. What is the secret of its success? To answer definitely, it works well because of the efficient organization of political parties, and of the potency of public opinion speaking through the leaders of those parties. Although as a matter of political right any member of the House of Commons may be present at the meeting of the Committee of Supply or of Ways and Means and participate in the conferences, as a matter of fact none but the leaders commonly attend, and none but the representatives of some party or some faction of a party venture to take part in the discussion. This means that the study of the details of the budget is committed to a set of men

brought together by a process of natural selection, and presumably the men most capable and fit to deal with intricate subjects by virtue of their experience, their talent, and their political position. An inferior man, a new man, or a man who represents merely his personal views on matters of finance, would not be tolerated. He could not secure a hearing, for it must be remembered by one who desires to understand the English Constitution that a healthy Englishman is by nature impolite.

The method of procedure in the committees is as informal as the unwritten rules respecting the constitution of these committees are rigid. The discussion, especially at the initial stages, and when there is no great question of national policy at issue, is somewhat conversational in character. After the introduction of the budget it is in place for the opposition to ask questions, ostensibly to elicit information, but in reality to embarrass the government. The result is that any weak point in the policy of the government will surely be brought to light; and while the English ministry is very jealous of hesitancy on the part of Parliament to sanction its estimates for expenditures, it has always manifested a willingness to modify its policy for raising revenue to meet the criticisms of either political friends or foes. The English method of studying the budget is not the product of design, but of an historical development. It fits English character and conditions. It realizes the two essentials of a good organization, namely, a small body of experts brought together for free discussion, and so organized as to include all the interests which have a right to be heard on financial affairs.

(2) *The Practice in France.*—The French method of organization as compared with the English is highly artificial. The Chamber of Deputies is divided into eleven bureaus or groups, the division being made by lot. Every legislative proposal is referred to these groups, where, according to the theory upon which they are organized, it will receive a cursory examination, and all general principles respecting it will be determined. Each group then appoints a certain number of its members, who, in connection with members similarly appointed from the other groups, form a legislative committee. The duty of this committee is to study at leisure and in detail the legislative project in question. The number usually appointed from each

bureau is one, which results in a legislative committee of eleven members; but in the case of the budget three members are appointed from each bureau, so that the Budget Committee comprises thirty-three members of the Chambers of Deputies. It is in this committee thus constituted that the serious study of the budget takes place in France.

Does this adjustment commend itself to general confidence? In the first place, it is said that the idea of a preliminary or even cursory study of legislative proposals in the several bureaus is not realized in practice. Thus the theory breaks down at its most vital point, namely, as a plan which requires every legislator to study every bill. The bureaus have come to be in reality the machinery by which the effective committees are appointed, and judged from this point of view the arrangement seems of doubtful expediency. The bureaus, it will be remembered, are appointed by lot, and the most one can expect from a committee made up of representatives of bureaus so created is that it will reflect the average ability of the Chambers. A matter, however, of such paramount importance to the nation as its fiscal policy should be committed to nothing less than absolutely the best talent and experience which the country affords.

The French system may do worse than commit the study of the budget to a committee composed of men of average ability, it may bring together men of decidedly inferior talent. It is conceivable that chance should throw the only eleven men preeminent as financiers into the same bureau, which would mean that three only out of the thirty-three members of the Budget Committee would be fitted for the task assigned. This is doubtless an extreme assumption, but it indicates what may be the character of committees made up of representatives of bureaus chosen by lot. As against this criticism it is urged that the Budget Committee is sufficiently large to guarantee, according to the doctrine of chances, that some of the best men will surely be included. This may be true, but the ideal adjustment is one which claims for financial questions the attention of all the best men and none of the poor ones, and that in the form of a small and compact body of students.

The criticism here noticed has been urged in France, and in 1887 the Budget Committee was chosen by ballot in the

Chambers The result of this experiment did not, however, seem to justify a permanent departure from the accepted rule, for the old method of appointing the committee was again resorted to the succeeding year It should further be noted as a partial relief from the criticism urged above that the task imposed upon the Budgetary Committee is to study the detail of financial propositions "in order to facilitate general discussion" This differs from the policy in England, where the vote of the Committee on Supply or of the Committee on Ways and Means practically disposes of the question at issue This is the important point in the comparison The English committee feels responsible for its decisions, while the deliberations of the French committee are relieved from that sense of responsibility which attaches to a determining, if not a final, vote While the French system may be conformable to French character, and so defensible from that point of view, it certainly does not meet the requirements of an ideal organization for the study of the budget The committee to which the study of the budget is given over is not a small body, it is not necessarily composed of experts, and there is no guarantee that it will represent all interests which have a right to be heard The determining discussion will probably, under such an organization, take place in the Chambers, a practice which will inevitably lead to corrupt legislation, because it invites bargain with factions in order to secure a sufficient number of votes to pass the main measure.

(3) *Practice in the United States*—At the time the Federal Government of the United States was created it seems to have been the accepted theory that legislation ought to be the direct product of the deliberation of Congress The necessity of special organization for the study of special questions was not apparent, since the interests involved were less complex, the legislative body less numerous, and the questions presented for consideration fewer than at the present time The committee system was regarded with jealousy and was of slow development. In 1802 there were but five standing committees in the House of Representatives, and it was not until 1816 that the Senate consented to a standing committee. The logic of necessity, however, proved stronger than a theory of government, and the committee system developed, until at the present time there are between fifty and sixty standing com-

mittees of the House, and over forty standing committees of the Senate, regularly appointed each session of Congress. It is not too much to say that the committee system of legislation is developed in the United States in its most extreme, and, as some of its critics assert, its most tyrannical, form.

It would seem from the fact that the legislative body is broken up into a large number of independent committees that this country conformed in a general way to the parliamentary practices of France rather than of England. In form this is true. But when one considers the manner in which committees are appointed, and the influence which they have acquired, they will be recognised as possessing a legislative character peculiarly their own.

It should be noted in the first place that all committees of the House of Representatives are appointed by the Speaker. But the Speaker is a member of the body over which he presides and owes his election to the votes of his fellow members. The election of a Speaker is one of the most significant events in the political history of a Congress, since it indicates with considerable clearness the colouring of the laws likely to be passed by the dominant party. It is well known before the election takes place who will be the chairmen of the important committees. The Speaker is the leader of his party in the House, and must from the pressure of his situation appoint the strong men of his party to the leading positions. Thus party responsibility is recognised in the organization of Congress for the consideration of bills, a result which would be impossible should the appointment of committees be intrusted to chance, as in France.

It should in the second place be noticed that the chief concern of the Speaker as the leader of his party is to secure from the committees such reports as will readily be enacted into law. He cannot, therefore, in making up the committees ignore the leaders of the opposition, nor the representatives of any interests or localities which have peculiar claims to be heard on the question in hand. There is thus secured by virtue of political pressure what in England is secured by natural selection, namely, a strong representative committee for the consideration of all important bills.

The third point in which the American committee system has developed a character of its own pertains to the degree of

influence which these committees exert Inasmuch as the budget committees, appointed in the manner described, are sure to be composed of strong and representative men, all arguments likely to be presented in an open session of the House will find their clearest and most forceful expression in the previous sessions of the committees This means that the serious study of the budget takes place in the committees It is here that witnesses are examined, testimony taken, and the pleas of interested parties granted a hearing It is here, also, that comparison is made between different measures, that consideration is given to details of items, and that all questions pertinent to a sound judgment upon the project in hand are presented and discussed As a matter of law no bill can be legalized without a vote of at least a majority of the Representatives, as a matter of practice the laws upon which the Representatives may express themselves by vote are determined by the committees. The rules of the House require that all committee reports shall be considered in the committee of the whole Any member of the House has at this time the right to submit an amendment, or indeed to propose a bill to be substituted for the report of a committee; but, so long as the committee retains the confidence of a majority of the party in power, no such amendment or proposal can influence legislation unless approved by the committee in charge of the bill under discussion

The means by which the directing influence of the committee is retained are simple in the extreme It is a rule of the House that no bill can be discussed until it has passed through the hands of its appropriate committee, and this gives to the chairman power to "kill" an irregular bill by refusing to report it It is true that the House may order a report, but a motion for such an order will not be carried unless some considerable portion of the party to which the chairman of the committee belongs are dissatisfied with his leadership, or are more interested in the particular measure than in preserving party discipline When to this is added the custom that a member cannot gain the recognition of the chair to propose an amendment except he has previously made some arrangement with the chairman of the committee it is pretty clear that the committee is complete master of the situation That Congress should tolerate such tyranny (as some are pleased

to call it) is perhaps its best justification. The truth seems to be that the committee system is essential for the transaction of business. The guarantee against the too arbitrary use of this great authority is found in the fact that the chairmen of the important committees are the influential men in the party to which the people have intrusted the conduct of the government, and as such they feel party responsibility. The chief concern with them is to secure votes for the measure upon which they have staked the future of their party, and this renders it highly probable that due consideration will be shown in allotting time for debate, and that legitimate interests will be granted opportunity to be heard. It is doubtless true that the power of a dictator is granted the chairmen of the great committees, but it is a power that can, as a rule, be exercised only so long as it is not used in too dictatorial a manner.

A careful consideration of the political, constitutional, social, ethnological, and geographical conditions of the American people will, it is believed, lead the student of finance to appreciate the committee system as well adapted to meet the peculiar needs of the American people. It conforms, so far at least as financial measures are concerned, to the three requirements of a good organization for the study of the budget, namely, a study of the budget by a small body of men, by a body of men who are experienced in political affairs, and by men who represent fairly well parties, factions, sections, and interests.

27 Should All Moneys be Voted Annually?—Having discussed the form of legislative organization we are prepared to consider certain other questions of parliamentary procedure which arise in connection with the passage of the budget to its vote. Important among these questions is the one which asks if all moneys should be voted annually.

(1) *General Considerations*—The point which here lies in controversy cannot be determined in a very definite manner, at least no answer can be given of such a sort as to be of universal application. The extent to which permanent appropriations may be used with safety (this being another way of stating the question) depends in large measure upon the stage of development at which a people have arrived in their realization of constitutional government. It is one of the

lessons of history that the executive cannot be trusted to fix the amount and determine the character of public expenditures, no matter what the form of political organization, for such a concession would deprive the people, or their representatives, of any influence in the shaping of public affairs. Strictly speaking, it lies in the theory of constitutional government that every item of expenditure should be submitted each year for legislative sanction; and it is but reasonable to conclude that, so long as any uncertainty exists concerning the respective political rights of the government and the people, it is not safe to go very far in voting permanent grants of public moneys.

Looking at the political situation as it exists among most peoples of Western civilization, the right of popular control over public affairs is so fully recognised, and the various checks upon the arbitrary use of public authority so well developed, that the necessity of an annual sanction for every item of expenditure has in large measure passed away; and it must be admitted that certain embarrassments arise whenever it is attempted to adhere strictly to the policy of annual appropriations, and that it is for this reason that permanent appropriations are regarded with favour. It may be well to notice the character of these embarrassments.

In the first place, an unnecessary vote is a waste of time, and thus, in view of the large number and great variety of questions presented for the consideration of the legislative body, is a serious matter. Permanent appropriations, therefore, are justified on the ground of economy. In the second place, it should be observed that the larger the number of items in the annual appropriation bills the less likelihood is there that adequate study will be given to those parts of the bills which need the closest scrutiny. Thus the importance of care in the consideration of questionable items suggests that at least those items respecting which no possible doubt exists should be provided for by permanent legislation. Of more importance, however, is the fact that, in the absence of permanent appropriations, the government would find great difficulty in making contracts which involve financial responsibility—a result likely to be attended with serious consequences, since it would render impossible the performance of many functions which lie within the legitimate sphere

of government. It would, for example, preclude the consideration of a system of public improvements, since the capital for such improvements must be collected by an issue of public bonds. It would, also, seriously embarrass a government in its attempts to make headway against such a fiscal emergency as is sure to arise in case of an expensive war. In any circumstances in which it is desirable to place at the disposal of government an amount of capital greater than its ordinary income serious difficulties would be encountered should the ability of the legislature to guarantee payments for a series of years be in any way impaired. From the point of view of administrative efficiency, therefore, permanent appropriations are highly desirable.

It may be said as against the last of the above considerations that a sovereign State cannot be forced by legal means to regard its obligations, and that what is considered a permanent appropriation by one legislature may be repealed by the next. This is doubtless true, but it is also true that greater confidence is felt in a law which makes provision for an annual payment for a specified series of years than in the caprice of successive legislatures. One who has observed the financial history of free peoples must recognise that the moral sanction which among self-respecting democracies attaches to permanent appropriations when they are a part of a public contract, either directly expressed or implied in the conditions under which the contract originated, does, as a matter of fact, give an added value to the promises of government, and enables the State to enter upon many lines of activity, or to make headway against fiscal emergency, which would lie beyond its ability should every item of expenditure be voted upon each year.

The general conclusion to which the above discussion seems to point is as follows. In the first stage of the development of constitutional government—that is to say, so long as the question of the residence of control over public policies is still in controversy—permanent appropriations are not recognised as in harmony with the interests of the best national development; but when this controversy has been settled through the substitution of popular sovereignty for proprietary monarchy the considerations which support the policy of annual appropriations are no longer pertinent. The practical question,

therefore, seems to be, not whether permanent appropriations should or should not be used, but what class of expenditures may be safely and advantageously provided for by permanent legislation. On this point it may be well to inquire respecting the practices of the leading constitutional peoples.

(2) *Practice in England*—In England there has grown up quite a list of permanent appropriations, covering in the aggregate about one-third of the total of annual expenditures. These are paid out of what is known as "the consolidated fund," and comprise at the present time the interest and principal on the public debt (so far as the debt is paid through annuities), the civil list, pensions (civil and military), salaries and allowances to certain independent officers, courts of justice, and a miscellaneous series of expenditures, including guarantees of interest upon the debts of certain foreign countries. The consolidated fund was created after the Revolution of 1688. A knowledge of the history of this revolution and of the century and a half preceding is necessary to correctly interpret the creation of this fund. It aimed to draw a line between the revenue of the king and of the nation. "The funds destined to the expenses of the crown became entirely distinct from those destined to the expenses of the State. This is the origin of the civil list." As time went on, however, other expenditures were charged to this fund, until at the present time provision is made in this manner for all obligations which rest on contract or arise on account of permanent institutions or definite demands.

The principle of permanency is carried yet farther on the side of income, the duty on tea and the income tax being the only sources of revenue which are now submitted to annual vote. This was also true of the duty on sugar until 1874. Four-fifths of the annual revenue of England is now provided for by permanent legislation. The question of permanency, however, is relatively of less importance when considered from the point of view of income than from the point of view of expenditure, since it is in connection with appropriations rather than taxation that the policy of government is brought into the foreground. For this reason the permanency of revenue laws is not subjected to special consideration.

(3) *Practice in France*—In France the question of permanent appropriations has been the subject of considerable dis-

cussion, but without any very definite results. It was urged by Mirabeau in the great debate of 1789 that no tax should be voted for more than a year except the one devoted to the service of the debt and the civil list. In this form the idea failed to secure support, although in the Constitution of 1791 it is explicitly stated that "under no pretext shall the funds necessary to the satisfaction of the debt or the payment of the civil list be liable to either refusal or suspension." In 1827 the matter was again brought forward for consideration in the form of a proposal that the budget should be divided into two parts, namely, the budget of the consolidated funds and the extraordinary budget, the former comprising all permanent and fixed services, the latter all new services and all charges of an accidental or temporary nature. The charges against the consolidated fund were to be permanent, and thus, according to the author of the proposal, the Chambers would gain considerable time, which might be devoted more advantageously to the examination of the new expenses. But this proposition was not adopted, and, as Stourm remarks, "the French budget continues to reproduce each year all those columns of figures which the ministers and chairmen of committees comment upon without ceasing, only to accede at last to the inevitable grant." *

(4) *Practice in the United States.*—The practice in the United States may be simply stated. Appropriations are divided into three classes, known as "annual," "permanent annual," and "permanent specific" appropriations, and the annual appropriations embrace all not included in either of the other classes †. The idea underlying permanent appropriations in this country is about the same as in other countries. From the administrative point of view the definition submitted by Mr. Sherman when Secretary of the Treasury is perhaps adequate. He said: "The words 'permanent appropriations' should be confined to appropriations such as private bills,

* Stourm, *Le Budget*, p. 307.

† "The general policy now is to construe all appropriations as annual unless a contrary intention is expressed in the act, or it clearly appears in the character of the object or service appropriated for that Congress must have intended the money to be available until the object is fully accomplished, or the service fully completed."—*Report of the Secretary of the Treasury*, 1894, p. lxxvii.

where nothing is left to executive officers for examination or inquiry except to identify the party or to comply with some specific duty pointed out by a specific appropriation." * From this it would seem that any expenditure of money fixed by the terms of a contract, or which occurs on account of an existing law and may be definitely calculated because the terms of the calculation are expressed in the law, or for assured compensation to certain officers, may with safety be made exceptions to the rule of annual vote. In how far this generalization applies to the practice of this country may be seen from a statement of permanent appropriations as they exist in the United States. They embrace the following objects of expenditures:

First. Salaries of public officers not political, as judges of the Supreme Court.

Second. Salaries and expenses of officers whose duties are essential to the carrying on of the government, as the supervisors at elections; salaries and expenses of collecting customs.

Third. Payments to institutions under the patronage of the government, as the Smithsonian Institution

Fourth. Constantly recurring claims, such as overreceipts in taxes, drawbacks, errors, and the like

Fifth. Permanent claims which are determined by calculation according to the terms of some explicit law, such as interest on the public debt, the amount due the sinking fund, and the like.

None of the above payments can by any possibility come into political controversy, and under the practice of periodic elections it is not necessary that Congress should expend time in making these appropriations each year.

The chief difficulty in administration pertains to the interpretation of "permanent specific" appropriations. The law upon this point is in the form of an exception to the general statement that "all unexpended balances of appropriations which shall have remained upon the books of the treasurer for two fiscal years are to be carried to the surplus fund and covered into the treasury." The language of the exception is as follows: "That this proviso shall not apply to permanent specific appropriations, appropriations for rivers and harbours,

* Letter of the Secretary of the Treasury to Hon. Samuel J. Randall, Speaker of the House, December 14, 1877.

lighthouses, fortifications, or the pay of the navy and marine corps, but the appropriations named in this proviso shall continue available until otherwise ordered by Congress"*. The idea underlying this provision for permanent specific appropriations seems to be that a service approved by Congress, and of such a nature that serious damage would ensue from an interruption of work once begun, and of such a sort also that the time and conditions for making the expenditures cannot be fixed by law, should be granted an appropriation which, while definite in amount, is indefinite as to the time of expenditure. This is shown by the services specifically named in the law, as also by the practice of interpreting appropriations for public improvements, such as Yellowstone Park, Military Park, Fort Ethan Allen Military Reservation, and the like, as permanent specific appropriations. This is quite in harmony with Mr. Sherman's definition, in the communication already referred to, when he says: "A specific appropriation is one where the amount, or subject, or person is designated particularly or in detail. It may be and usually is permanent in terms because not limited as to time, like an annual appropriation."

Permanent specific appropriations, then, may be characterized as appropriations for a service which would be endangered should Congress undertake to make any definite statement respecting the time or rapidity with which the moneys assigned to its support should be expended. It holds in a sense the same relation to the administration of public affairs that a construction account does to the administration of a railway corporation. The appropriation is not properly classed as current operating expenses. It is more akin to an investment of capital. For this reason also it appears that the chief question for the legislature to decide is whether or not a definite amount of money can be expended for the service in question, leaving the time and manner of expenditure to the administrative officers.

On the side of income all revenue laws in the United States are permanent; that is to say, they continue in force until by the enactment of some subsequent law, or by an amendment at some subsequent time, the law is repealed or its conditions changed.

* Section 5 of the Act of June 20, 1894.

From the financial point of view a serious criticism may be urged against this practice, in that it does not contemplate the annual adjustment of income to expenditure. In order to insure adequate revenue for all years, it is found necessary to provide a surplus in ordinary years. So long as a government can expend this surplus in the reduction of debt, or in some other flexible demand, no serious difficulty, perhaps, will arise on this account, but should there be no means of expending in a judicious manner the surplus accruing in prosperous years its influence upon business conditions, as also upon current appropriations, will be decidedly injurious. Much better results would follow if one or two sources of revenue were brought annually to the consideration of Congress, and the rate of taxation for each year adjusted in such a manner that, added to the receipts from permanent revenue laws, the aggregate revenue should be made to conform to the aggregate of appropriations. Reference has already been made to the fact that all sources of income in England rest upon permanent laws, with the exception of the income tax and the tax on the importation of tea. This is not due to any peculiar constitutional dangers that reside in these taxes, but these taxes are reserved for annual consideration and their rates are adjusted each year, so as to preserve a balance between annual income and annual expenditure. With the exception provided for by this consideration, the theory of permanent revenue laws must be approved. To extend this permanency to all revenue laws, however, results in loose appropriations and finally in the necessity of providing for an increase in revenue.

(5) *Practice in Germany*—The German people, who, from the point of view of constitutional government, cannot safely go as far with permanent financial legislation as the people of England or of the United States, do, as a matter of fact, go much further. Provision for the army, for example, is made for a period of seven years, and in this manner practical control is given to the Emperor over all those varied services and far-reaching policies which in the actual condition of European politics are bound up with military authority. The question at issue was put very concisely by Bismarck when, in 1887, he impatiently exclaimed: "Ought our army to be the army of the empire or of the parliament? This is the ques-

tion" With regard to other expenditures also, the government enjoys guarantee that established institutions will be maintained. All that is left to the representatives of the people is the limited right of denying grants for new services. From the administrator's point of view this is undoubtedly an admirable adjustment, since it insures stability in the military and the civil service, and without stability efficiency cannot be secured, from the point of view of constitutional government, however, such an adjustment cannot be defended, since it regards the political liberty of the individual as of less worth than efficient administration.

The lesson to be learned from the practice of Germany is that permanency in the assignment of moneys to the various branches of the public service is one of the requisites of efficient administration, and it should be the ideal of those peoples who aim to develop popular government to so strengthen the non-financial checks upon the arbitrary exercise of power as to permit an extension of permanent appropriations. England and the United States seem to have assigned greater importance in the adjustment of their budgetary methods to political liberty than to administrative efficiency. Germany, on the other hand, assigns greater importance to administrative efficiency than to political liberty. The ideal of the perfect organization is efficiency with liberty, and the rule for determining what class of expenditures should receive annual sanction, and what class should rest on permanent legislation, will be developed out of a conscious effort to harmonize these two conflicting interests.

(6) *Conclusion*—The foregoing survey of the practice of governments shows that the question of permanent appropriations is in a somewhat unsatisfactory condition. The proposal which was rejected in France in 1827, that expenditures for new services should be the only ones to receive the approval of the current legislature, admits of many arguments in its favour, but a consideration of the kinds of expenditures which this would place outside of current parliamentary discussion shows it to be too comprehensive in its character. A newly established service should receive the repeated votes of successive legislatures before it can safely be regarded as among the established institutions of the State. The difficulty seems to lie in the fact that no scientific classification of ex-

penditure has ever been undertaken for the purpose of grouping together those which bear the same social significance, and, consequently, no general rule can be laid down. There are some grants that should never be made permanent, because they pertain to services which, though constantly recurring, do not recur under constant conditions. There are other grants which should not be permanent, because assigned to the support of an imperfectly developed branch of the public service, and if made permanent the future development of the service in question would be endangered. Such, for example, is the grant for the Interstate Commerce Commission. While the idea underlying the Commission may be accepted as sound, and the Commission itself accepted as a permanent institution, the law upon which it rests is so imperfect as to preclude the satisfactory performance by the Commission of the duties assigned to it, and it would be unwise to make the expense of this bureau a permanent charge before the principles of railway regulation are crystallized into a rule for permanent practice. The question of railway regulation in its present unsatisfactory condition should come annually before Congress for discussion, and the only guarantee for this is found in the necessity of annual appropriations for its support.

It is, on the other hand, an unnecessary expenditure of time to vote each year the expenditures for the courts. The judiciary is a fixed institution, and the amount necessary for its support is a matter of bookkeeping and not of policy. This is a good illustration of a grant which in all countries may safely be made permanent. All expenditures which rest on contract, also, should, for reasons already stated, be permanent in character. This question of the permanency of revenue laws, like so many questions which arise in the Science of Finance, must be determined by each nation in view of the political, industrial, and social conditions in which it finds itself.

28. In What Form should the Budget be Voted?—It has been conceded that a budget should be presented to the legislative body as a complete and comprehensive document. It remains for us to consider what form the budget should assume for the purpose of a vote. So far as laws providing income are concerned, there seems to be little opportunity for difference of opinion. The discussion which has taken place

upon this question pertains for the most part to appropriations, the practice respecting tax laws being in large measure determined by the nature of the laws themselves. With regard to appropriations, however, there exists the greatest diversity in practice. In some cases the appropriations are gathered into a single bill for the purpose of vote, while the separation of appropriations in such a manner as to require three or four hundred independent votes on the part of the legislature is not uncommon. The question in hand, therefore, is a pertinent one, and inquires if there be any principles by which an appropriate classification of expenditures for the purpose of vote may be arrived at.

Some light is thrown upon this question by the observation of Leroy-Beaulieu, who says: "The right of voting taxes bears with it two separate rights, first that of verifying the necessity of the tax itself, and second that of assigning the proceeds of the tax to a definite purpose"; and it will be at once conceded that any division of the budget for the purpose of vote more minute than is necessary to attain these ends will be the occasion of embarrassment to the legislative body. On this point those considerations urged above in favour of permanent appropriations may be accepted as applicable to the case in hand.

Nowhere has there been a greater variety in practice than in France. In that country the appropriations were voted *en bloc* under the first republic and under the first empire; by ministries during the first part of the Restoration and the first part of the second empire, by grand sections at the end of the Restoration and once during the second empire, by chapters in 1830, in 1853, and since 1869.

The practice of voting the budget by chapters has much in its favour provided these chapters represent some definite interest. The danger, however, is that the divisions will be made so minute that the same interest or service will claim from the legislature several separate votes, in which case one is not sure in giving his approval to an appropriation what additional sums may be necessary to make full provision for the service in question. This being the case, it is likely that such portion of a given service as first receives the attention of the legislative body will secure a larger share of the funds which may appropriately be granted than is justified by its relative importance. The same danger arises as between the several

interests themselves, except they be combined in some comprehensive group of services. Nothing is more common than that ample provision is made for the service which first presents its claim, and that other services equally meritorious should find the funds exhausted before their claims are presented. This is the natural result where the legislature votes the budget in the form of a large number of unclassified chapters. Such a method tends to destroy a just balance in appropriations, not only between various bureaus or departments which together make up the public service, but between the various interests that lie within the bureaus or departments themselves.

The custom of voting the budget *en bloc* or in a few grand sections is equally pernicious, since in this manner the vote is deprived of any definite and specific meaning and the administration is largely freed from legislative control. This would be equivalent to the practice which existed in England, when the extent of the influence of the legislature over expenditures was to limit the amount of money raised by taxes placed at the disposal of the sovereign for expenditure, a practice which existed in the American colonies also, previous to the adoption of the Constitution.¹ Thus the second of the two rights which Beauhieu finds embodied in the right of the people to consent to taxes is practically, or at least in large measure, given up where money is voted *en bloc*. As the interest of a well-balanced budget stands opposed to the voting of money by chapters, so the constitutional interest is opposed to the drafting of money bills by grand sections. The general principle seems to be that the chapters submitted for final vote should not include an aggregate so large that each vote fails to have a definite and precise meaning, on the other hand, that the appropriations should not be divided into so many bills as to endanger a just balance between the various lines of public service. The appropriate method must be a compromise between these conflicting interests, and each nation must formulate its appropriation bills in view of its own peculiar constitutional requirements.

One suggestion a little more definite in character may perhaps be submitted. In view of the way in which estimates are made, the budget on the side of appropriations will, as origi-

* Goodnow, *Comparative Administrative Law*, Vol. II, p. 276.

nally presented, conform to the organization of the government for the purpose of administration, and there are many reasons in favour of the rule that a decisive vote in the legislature should conform to what may be termed the administrative classification of expenditures. This seems necessary in view of the fact that the appropriation of moneys for a future service is, in a sense, an examination of the manner in which money has been expended for a past service. Applying this suggestion to the United States, the budget might adjust itself to the classification of expenditures recognised in "The Book of Estimates." That classification presents the estimates under the following heads: Civil Establishment, Foreign Intercourse; Military Establishment; Naval Establishment; Indian Affairs, Pensions, Public Works, Postal Service; Miscellaneous, including the District of Columbia.

In order to insure appropriate study of expenditures each of the above comprehensive services may be divided into a considerable number of chapters, each chapter representing some independent though subordinate interest. The votes upon these chapters, however, should not be regarded as decisive or final, and so far as such details claim the attention of the legislative body should be considered in committee of the whole. By no other means is it possible to secure well-considered and well-balanced appropriations. This rule is laid down with some confidence since the thought which underlies it is in large degree realized by the practice of parliamentary peoples.

Among the embarrassments to sound budgetary legislation none is more serious than the attachment to general appropriation bills of an irrelevant rider. By a rider is meant an amendment to a bill, or a clause injected into a bill, which is foreign to its main purpose. It commonly represents an interest so small or of so personal or local a character that it could not claim the attention of the legislative body if presented as a bill by itself. Being attached, however, to some important measure it receives approval, not upon its own merits, but because to disapprove it might jeopardize the passage of the principal measure. It may appear strange that an amendment which must receive the approval of the majority of votes cast can be attached to an appropriation bill, when in the form of an independent bill it would be unable to

command support and this could not be the case were the amendment in question the only personal or local interest which seeks enactment. The fact is, however, that there are many such interests, and where the parliamentary rules grant each member of the legislative body the right of amendment it is altogether likely that a majority of votes can be secured for a series of amendments through a combination of interests that have nothing in common except their desire to be legalized. On this account general bills of public interest are frequently obliged to carry a considerable number of irrelevant riders.

The embarrassment occasioned by irrelevant riders is in large measure obviated in England by denying the members of the House of Commons the right of making amendments, the only amendment possible being to cut down a specific appropriation. It is not even permitted to impose a condition upon the expenditure of moneys once granted. As has been already explained, the House of Commons approves or disapproves the bills for appropriation as presented to it. Should any member desire to make an amendment of importance, it is presented as a suggestion which may be accepted or rejected by the Government. In any case an amendment, except one to reduce an appropriation, must be referred back to the Committee on Supply. In this manner full responsibility is imposed upon the Government. No government could stand which permitted irrelevant clauses to make a part of the general appropriation bill.

The method by which the evil of irrelevant riders may be obviated where fundamental law prescribes a separation of the executive and administrative departments will receive attention in the following section, which brings into notice certain propositions for modifying the American system of budgetary legislation.

29. Reform of the American Budgetary System.—The evils of the American system of financial legislation are suggested by the phrase diffused responsibility. This is in part due to the separation of governmental functions into three general departments, a form of organization chosen after much deliberation by the framers of the Constitution because it was regarded by them as the best of possible adjustments for a democratic people. In so far as the evils complained of are

traceable to this source, it is futile to speak of a reform in budgetary procedure. The Constitution of the United States will never be amended as a result of any criticisms, however just, that may be urged by the Science of Finance. Moreover, there is a very respectable number of American citizens who see in the theory of balanced powers a higher ideal of constitutional organization than can possibly be entertained by a government in which any one department shall have attained supremacy. This being the case, any suggestions for overcoming the evils incident to the American system of budgetary legislation must content themselves with the idea of rendering effective the principle of responsibility under the conditions imposed by the American type of constitutional government.

(1) *Enumeration of the Defects*—It will add to the clearness of this analysis if a simple statement of the defects of the American system be submitted. From a consideration of the preparation and presentation of the budget it was learned that the principal evils arising in connection with financial legislation in the United States were as follows: First, that the Secretary of the Treasury is given no constitutional authority to control estimates, second, that responsibility for the preparation of the budget is divided in the legislature; third, that, although legislative power is given to the President by the Constitution, he cannot bring his influence to bear upon a bill while yet in its plastic state. So far as other points considered in the previous chapters are concerned, the American method of procedure seems to meet fairly well the requirements of sound methods of fiscal legislation. That is to say, we can approve the practice of the United States with regard to the date of the fiscal year, the rule of making estimates, and the form in which the budget should be presented.

The same general conclusion is arrived at when we consider the passage of the budget to its vote. The formal part in fiscal legislation is, on the whole, worthy of commendation; but in the voting of the budget, as well as in its preparation, there is no adequate responsibility. Finance bills are reported from many unrelated committees and specific appropriations are pressed to their determining vote without due regard to the aggregate of expenditures. The right of amendment, also, which is almost unlimited, endangers the harmony of

the bill, if indeed it does not threaten the integrity of its purpose.

(2) *Consideration of Remedies*—The evils that arise in connection with the established practice of financial legislation in the United States being thus clear and definite, is there also a clear and definite remedy? Upon one point there can be no question. Since diffusion of responsibility is the chief source of the evils complained of, greater concentration of responsibility must be the means by which those evils are to be overcome. It may serve to emphasize this point, as well as to show that the difficulties mentioned are not fanciful, if the suggested reforms which have been submitted from time to time be passed in review. In presenting this summary, the author avails himself of the concise statement of proposed reforms found in Dr Adams's monograph already referred to.

"The first suggestion is that the various financial committees be united, so that there shall be harmony in budgetary legislation. The revenue and expenditure sides of the budget would be much more likely to be carefully balanced by one committee than by several. This suggestion would probably result in better business methods, but it would not in any way affect the main question of effective responsibility. It would insure a more careful consideration of the relation between taxation and expenditure, but it could not secure to the people any real control over either the extent or purpose of such taxation and expenditure.

"A second suggestion is that the number of the members of the House of Representatives be diminished and that the committees be chosen entirely from the ranks of the majority. It is urged that by reducing the number of representatives the number of voters necessary to elect a representative is increased so that he is made a national instead of a sectional representative, with national rather than sectional responsibility. This is true only to a limited extent. It might be possible to gain an improved responsibility in this way, but not an effective responsibility. The fewer the representatives the greater will be the influence of any one representative's vote in deciding national policy, and moreover he will be inclined to view questions from a national rather than from a sectional standpoint. But this does not alter the measure of his responsibility to his constituents in any degree. The second

part of the suggestion is intended to make the party in power responsible for the propositions of its committees, but it does not appear how it will accomplish this result. In Congress to-day the majority in the House have a majority of their own number on every important committee. The responsibility of the majority is as effective under the present system as it would be if none but the members of the majority formed the committee. Neither of these suggestions touches the real trouble underlying the committee system of government.

"A third suggestion, which does recognise this evil, is that to the President shall be given the power of appointing the chairman and members of the committees of the House. The argument is as follows. This power could be given to the President without any radical change in the seemingly indispensable committee system. It would, it is true, greatly increase the power of the executive over legislation, but it would not be so apparent a change of the forms of government as to rouse the opposition of the people. It would bring to the voter the realization of his idea, at present erroneous, that in his vote for President he has a direct influence upon legislation. The President, by the appointment of members of committees whose ideas upon financial legislation agreed with his own, would become the one person upon whom the responsibility for such measures would rest, and it is fitting that this should be so, since the President is the only officer of importance for whom all voters have the privilege of casting their ballots. The President is the only person from whom it is possible to obtain an effective responsibility.

"The suggestion is interesting as the only one so far which clearly recognises and attempts to remedy the lack of responsibility in government. But it seems impracticable, failing to consider the possibility of a President whose political views do not coincide with those of a majority in the House. This may easily come about. Under such circumstances committees appointed by him, reflecting his views, could not possibly possess the confidence of the House, and no committee could hope to do efficient work unless supported by a majority. Such a committee would soon realize its dependence upon the majority, whose votes are necessary to carry out its propositions, rather than upon the President, whose power is limited to the privilege of suggestion.

"On the other hand, if the President, recognising the impracticability of appointing committees not in harmony with the majority, should lay aside his own plan for legislation and appoint the committee from among the members of the opposition, he would thereby make of no effect the result of the presidential election. He would thus cast upon the House a responsibility which, as has been seen, it is impossible to demand from that body. The suggestion would be practicable only when the President and the House were in harmony. At any other time it could only result in continual dispute between the executive and Congress.

"A fourth suggestion is that the United States adopt the cabinet system. There are several forms of this system, but the central idea of each is that of a Ministry responsible to an elected House of Representatives, and remaining in power only so long as the Ministry and a majority of that House are in harmony. In case of an adverse vote in the House upon some important question, the Ministry must either resign office to an opposition party or appeal to the country for vindication. The suggestion usually made is that the United States adopt, as far as possible, the English system, but whatever form of cabinet government should be selected it would involve a complete change in our institutions. The most important change would be the election of a President for a long term and placing him so far above ordinary party politics that he could interfere in no way in the conduct of national business. He would merely be the one to whom the Ministry, on loss of power, should surrender office. His position would be similar to that of the President of the French Republic today. The real head of affairs would be some member of the party in power who so far possessed its confidence as to retain a majority in the House of Representatives. The Speaker of the House would become a presiding officer simply, for no one could at the same time discharge the duties of Speaker and Premier. Elections would not take place at regular intervals, but on occasion of an appeal to the country. The Senate could be left as it is now and would in some measure serve as a check upon too hasty legislation, but even then the introduction of the system would necessitate both radical and minute changes in the present government.

"This suggestion involves much more than the mere reform

of budgetary rules, yet it is of importance for laying stress upon effective responsibility to the voters of the country, and it is difficult to see how the real control of the purse can be secured to the people without at the same time securing to them control of all questions of legislation. The most effective argument against the cabinet system is the doubt whether it is adapted to conditions in the United States.

"Still another suggestion likewise met to remedy the lack of responsibility is that of the Socialists. They demand that the offices of President and Vice-President, and the Senate, be abolished and that the government be carried on by an Executive Board elected by the House of Representatives. They propose also that all laws of importance shall be presented to the people for their direct vote. It is evident that a Board so elected would correspond nearly to a Ministry holding office, while supported by a majority in the House of Representatives, under the cabinet system. The socialist plan preserves elections at regular periods, and in truth an executive body elected directly by the Representatives, while the cabinet system does away with elections at regular periods and makes the executive body dependent upon a majority in the House, though not directly elected by them. The essential idea of the two suggestions is nevertheless the same—that this body is made responsible to representatives, and representatives to the people. The same objection holds against both, though in a greater degree against the socialist plan; namely, that they involve a radical change in the present form of government. If there is a way by which the desired results may be obtained without change of institutions, or with less change, that way merits more favourable consideration."*

The suggestion of the author of the monograph from which the above quotation is taken is of interest. Three changes are advocated, and briefly stated they are as follows.

First. The President and members of the House of Representatives should be elected for the same length of time.

Second. The choice of presidential electors should be made by districts within the States, instead of by States as units.

Third. The President should be granted the right of appointing the principal committees in the House. "The first of these changes would render necessary a change in the

* Adams, *The Control of the Purse*, pp. 226-229.

Constitution, the second would require primarily a change in custom and might involve a change in the Constitution, while the third would demand a change in custom only."

It is not necessary to consider at length the above suggestions, since they involve a constitutional amendment, and in view of the history of the former changes in the fundamental instrument of government which have been made during the past century, there seems no likelihood that the American people would interest themselves in an amendment the only purpose of which is to overcome an evil in fiscal legislation. A practicable remedy must be one that can be worked out either by a more perfect organization within the executive and the legislative bodies, or by an agreement between these bodies which would be in harmony with the existing structure of the State. As a contribution to the literature of the subject, the following suggestion is submitted, which, it is believed, recognises constitutional limitations and will, at the same time, prove to be simple and effective. The object which it sets before itself is to heighten the personal responsibility of the President and the members of the Cabinet for fiscal legislation, and to impose legislative responsibility upon the party in power.

First. The first step in this programme has already been suggested. It consists in the establishment of a budgetary committee which shall have full and exclusive jurisdiction over the form of the budget when presented to the legislative body for discussion and vote. This means that the Committee on Appropriations should be abolished, and that the duties which it now performs should be assigned to the Committee on Ways and Means, and that the right of other committees to introduce bills which either directly or indirectly legalize appropriations should be taken from them. In this manner there would be established in the House of Representatives—this being the body which according to the Constitution has the exclusive right of originating money bills—a committee of undivided authority. Both sides of the budget, that of income and of expenditure, would be studied by the same set of men, and the danger of unbalanced appropriations would be greatly diminished by giving them exclusive jurisdiction, so far as projects of law are concerned, over all items of expenditure.

Two criticisms will immediately present themselves.

A budgetary committee thus organized, it will be asserted, is not responsible in the constitutional sense of that word; and it will further be urged that the duties thus imposed are so extensive and exacting as to render their satisfactory performance impossible.

So far as responsibility is concerned, the criticism does not appear to be sound. It is true that resignation of the committee in case its projects of law are rejected in the House will not lead, as in England, to an appeal to the country, nor would such a result be logical, except in a country where the government is an administrative committee of the legislative body. It should, however, be remembered that the Constitution of the United States does require periodic elections, and that the party in power can only sustain itself before the people by showing that it has performed the functions intrusted to it in a fairly satisfactory manner. This at least is the extent of the political responsibility which is possible under the American Constitution. Moreover, the responsibility which is needed to overcome existing evils is not so much the political responsibility to the voter for the policy underlying fiscal legislation, as the responsibility which will lead to a careful and minute investigation antecedent to the expression of this general policy in a definite bill. If, now, the committee which we have styled the budgetary committee be intrusted with exclusive jurisdiction over the form in which all finance bills are presented, and if, in consequence, the right of the members of the House is limited to the acceptance or rejection of the bills as proposed, a mistake in the form of the bill comes to be a matter of party responsibility as well as a mistake in fiscal policy. The proposal suggested would result in making the great majority of the House of Representatives critics of a proposed measure rather than, as is now the case, centres from which independent measures may be projected. It would result in committee responsibility to the House; for, in case the committee could not agree upon a project of law acceptable to the House, it would of necessity resign, and make way for another committee which more perfectly reflected the desire of the party in power.

This of course brings up the question whether or not the Speaker of the House should continue to appoint the committees. On the whole it would seem wise to permit him to con-

tinue the exercise of this power, but he too, like the committee, should stand in jeopardy of a forced resignation in case his organization of the House for the transaction of business did not meet the approval of the body that elected him.* The theory upon which legislation in this country was begun considered that all legislation should come directly from the legislative body. The pressure of business rendered this impossible and has led to the establishment of a committee system, and many of the evils complained of arise from the fact that this system is but half developed. The suggestion presented above rests upon the conviction that legislation by committees is essential to the transaction of the mass of business which presents itself, and the only purpose of the suggestion is to establish committee responsibility.†

In further criticism of the plan suggested, it may be urged that the duties imposed upon a budgetary committee are greater than can be satisfactorily performed. This was the argument which led to the establishment of the Committee on Appropriations in 1865, but it may be doubted if Congress at that time sought relief for the Committee on Ways and Means in the proper manner. One acquainted with the usual methods of procedure is familiar with the fact that a considerable portion of the time of the members of important committees is consumed with reading documents from private parties upon private matters. Consider, for example, the amount of time consumed by the Committee on Ways and Means whenever a tariff law is under consideration. Consider also the personal appeals from all sides that come to the Committee on Appropriations. Now, it is evident that these interests should be voiced, and that those who are intrusted with formulating a project of law should have presented to them all the arguments and considerations necessary to a complete understanding of the situation. It is not, however, necessary that this important committee, which, for lack of a

* There is no way of curtailing the arbitrary authority of a Speaker except by taking from the members of the House the right to originate public bills.

† In response to the query that may present itself on account of the fact that committees are made up from members of both parties, the student is referred to the foregoing analysis of the probable efficiency of such committees. Cf. § 26, (3).

be organized as a committee of the whole or in legislative session. In this regard the practice in England would seem to meet the requirements of appropriate organization.

Third. Passing now to the other side of the question, that is to say, to the budget in the hands of the administration, it will be remembered that no inducement is offered the administration to formulate a governmental policy respecting either income or expenditures, and it is of course impossible that this should be established as bearing the stamp of legal authority without changing in a radical manner the existing political organization. While this is undoubtedly true, there is yet reason for believing that the report of the Secretary of the Treasury might be made a more dignified and important document, and that the position of the Secretary as head of the department might be made more influential within the administrative department of government, by means of a very simple resolution of the House of Representatives. Suppose, for example, the budgetary committee already provided for (or, indeed, existing committees) should pass a resolution to the effect that it would hold no communication respecting finance bills with any member of the administration, or with any officer or employé of the executive department of government, except through the Secretary of the Treasury. This would result, first, in creating a definite administrative policy respecting financial measures. It would give the legislative body means of securing official information respecting the willingness of the President to sign a proposed bill in case it should be passed by both Houses of Congress, and this would, in large measure, obviate the serious criticism upon the existing situation that the President is incapable of exercising the influence secured to him by the Constitution when it granted him the veto power, at the time when the finance bills are in a plastic state. It would open, also, an avenue of compromise between the executive and legislative departments of government which should be formally and openly recognised. Such a resolution, also, would tend to increase the authority of the Secretary of the Treasury in the matter of appropriations within the executive department itself. No practice is more effective in distorting the minor details of appropriation bills than the practice of direct communication between the subordinate officers

of the various bureaus and the members of the legislative body. Until this is done away with it is useless to look for the exercise by the Secretary of the Treasury of any conservative influence upon general appropriations. Such a resolution would give to him who, by virtue of his official position, represents the financial interests of the nation an authority in the making of estimates which he does not now possess. It would go as far, perhaps, as it is possible to go under the present political organization, or, indeed, as it is desirable to go, toward establishing an authoritative financial policy of the government.

An important consideration in support of the change in fiscal legislation above suggested is found in the fact that it would accomplish the result contemplated by those who desire that the President should be authorized to veto parts of bills, while approving other parts. This of course lies outside the range of our present discussion since we have confined ourselves to such reforms as are compatible with the existing Constitution. It is worthy of remark, however, that the advocates of the discriminating veto rest their arguments upon the prevalence of irrelevant riders to important bills. Now it is clear that the plan above suggested renders irrelevant riders highly improbable if not impossible, and on this account does away with the necessity of any constitutional extension of the executive power in legislative matters. This is a consideration which may properly be urged in support of the plan submitted.

CHAPTER IV.

RESPECTING DISCREPANCIES BETWEEN THE EXECUTED AND THE ESTIMATED BUDGET.

THE THREE INTERESTS INVOLVED.

THE SUPPLEMENTAL BUDGET

DEFICIENCY BILLS OR SUPPLEMENTAL CREDITS.

ADMINISTRATIVE APPROPRIATIONS.

(1) Extension of Grants.

(2) Transfer of Credits.

(3) Indefinite Appropriations.

THE responsibility of the law-making body for financial legislation does not cease with the vote of the formal budget. Discrepancies are sure to arise between estimates and results when the budget is placed in execution. These discrepancies commonly become apparent to the administration before the close of the year for which the laws are voted, and it is imperative that some regular and orderly means should be provided by which errors in estimate may be rectified as speedily as possible, and with as little embarrassment as possible to the interests involved. To consider the most appropriate method of covering discrepancies between the executed and estimated budget is the purpose of this chapter.

Although estimates may err on the side of income as well as on the side of expenditure, it is not generally regarded as necessary on this account to change the orderly course of revenue laws until the matter comes up in connection with the next regular annual budget. The question of aggregate income and aggregate expenditures is not commonly made the subject of corrective or supplemental legislation. Should general receipts for any reason fall below the estimate, so that a deficit stares the administration in the face, the legislature might, it is true, recall appropriations for relatively unimportant ser-

vices and assign the money thus saved to the support of services regarded as relatively more important, but this would give rise to such confusion, if undertaken by the legislative body, that the practice is not commonly resorted to. It is generally acknowledged that some temporary provision should be made for a general deficit in order that the situation may receive adequate consideration when making provision for the succeeding fiscal year. This contingency of a general deficit through shrinkage in revenues is too important a matter to be dealt with under the pressure for quick decision usually attending supplemental legislation. It will therefore not be considered in this connection.

The same conclusion follows should the source of income be unusually prolific, so that it becomes evident in the middle of the fiscal year that a surplus will result from the continued operation of existing fiscal laws. A general surplus, like a general deficit, is not commonly made the occasion for corrective legislation.* It would be adequate, in the absence of other considerations, to urge against such a procedure that arbitrary changes in the rate of taxation, or unadvertised changes in revenue laws, or changes made at unusual times, are not approved by financial principles. The importance of stability in matters of taxation confines the revision of rates to the orderly annual budget.

The errors in estimates which are the occasion of such embarrassment as to warrant revision during the course of the year to which the estimates apply pertain to inadequate appropriations for specific services, or they arise on account of some unusual or unforeseen demand. The assumption is that the service itself was approved when the general appropriation bills were passed, or that the demand, being of the nature of an exigency, will command immediate approval upon presentation. The difficulty to which the legislature must address itself is found in the fact that the administration has not been granted sufficient money to carry on approved service until the close of the current fiscal year, when a new appropriation for its support may be expected. How shall the period be covered?

* It should, however, be made the occasion of providing some means of returning the surplus to the ordinary channels of trade. This question, however, finds proper treatment in connection with the analysis of financial organization and administration. Cf § 36.

for those months that remain after the old appropriation is exhausted and before the new appropriation is opened ? Such is the question presented for discussion

30. The Three Interests Involved—Before considering this question in detail it may be well to call attention to the three interests involved. These are the financial interest, the administrative interest, and the constitutional interest

First The financial interest demands that the expense for services should be kept at the lowest possible point consistent with efficiency, and that an equilibrium should be maintained, so far as possible, between the aggregate of income and the aggregate of expenditure. It has already been pointed out that looseness in estimates on the part of the legislature would not be conducive to good budgetary results, it is equally true that any looseness on the part of the administration, such as would be sure to follow if executive officers were granted any considerable degree of liberty in the expenditure of money, would tend to destroy clearness and certainty in the accounts of the government. The financial interest, then, demands that the administration should observe in every particular the letter of the law

Second The administrative interest claims that a work once undertaken, or a service once entered upon, should not be checked for want of supplies before brought to completion. It would be highly injurious should a diplomatic service, for example, which, on account of some exigency in foreign relations, proves to be more expensive than was contemplated in the bill of appropriations, be arrested for lack of funds before the service is brought to completion. Cases have arisen in which important prosecutions by government have been caused to fail as a result of inadequate appropriations. Reference has already been made to the unnecessary expense resulting from the interruption of services like public works due to inadequate appropriations. Such considerations as these make it apparent that some orderly and regular means should be provided by which the administration may be placed in possession of funds with which to continue an approved service in case the moneys appropriated shall have been expended before the new appropriations become available

Third The constitutional interest, which is the third of the interests to be considered in providing for the orderly covering

of casual deficits, stands opposed to looseness in fiscal affairs, whether on the part of the administration or of the legislative body, but especially is it opposed to the exercise of any authority by the administration in the expenditure of money beyond what is definitely stated in the law. This thought need not be expanded. It is fundamental in the theory of the budget, and has found frequent expression in the foregoing discussion.

A review of the practice of nations in covering deficiencies in orderly appropriations, or in providing for relatively unimportant exigencies, discloses three lines of possible procedure.

1. A supplementary budget may be voted, designed to correct the errors that have been discovered.

2. Deficiency bills may be passed, or some provision made by which a deficient appropriation may be increased.

3. The administration may be authorized to make provision for orderly mid-year deficits.

Each of these methods will be made the subject of separate consideration.

31. The Supplemental Budget.—A supplemental or corrective budget is one introduced as supplemental to or corrective of fiscal laws already in course of execution. It is, however, an independent budget, and not an amendment to the regular appropriation bills. It is a second or mid-year budget, and as such opens up the same field of discussion that was traversed when the original budget was presented for consideration and vote. It is intended by those who advocate this procedure that the supplemental budget shall supersede the original bill, and it is quite in order for it to modify the conditions upon which moneys have been expended by executive officers during the first few months of the fiscal year. This general statement presents the character of the supplemental budget much more clearly than could be done by a formal definition, and it has the added advantage of bringing into prominence the consideration upon which this method of covering a deficit must be approved or disapproved.

The principal argument urged in favour of supplemental budgets is that by means of them the conditions under which the annual budget was originally voted are again brought to the notice of the legislature, and that opportunity is thus

afforded for correcting any errors of any sort that may have been discovered. To put the matter in another way, the supplemental budget is defined as a means of bringing the effective estimates yet closer to the execution of the laws that legalize them. It is indeed difficult to see how they may be brought much closer, since the estimate underlying a supplemental budget takes place within the fiscal year to which the appropriation applies. While admitting the general fact assumed by this argument, it may be doubted if the end which it holds in view commands unqualified approval. The general discussion upon the merits of a service, or upon the relative importance of the several services, which the legislature designs to support should take place before they are assigned to executive officers for administration. The budget once voted, the administration should be granted as long a period as possible free from the interruptions of further legislation. The year contemplated by the original law is short enough—indeed, it is too short—for the best administrative results, and the convincing argument against the policy of supplemental budgets is that by means of them security against interruption cannot be guaranteed for more than five or six months. It must not be overlooked that sound financial administration is as important to good government as sound financial legislation, and it calls for no extended analysis to perceive that serious mischiefs will follow a general feeling of insecurity on the part of executive officers, such as must result from opening up the general field of discussion by a mid-year budget. It is essential to the orderly conduct of public affairs that questions of administrative policy should not be open to constant discussion and possible revision, and it is largely on this account that nations have fallen into the practice of correcting errors of estimate in such a manner as to leave unimpaired the conditions under which the original appropriation was voted.

Another consideration against supplemental budgets is found in the fact that they lead to an uneconomical use of the time of the legislative body. The chief embarrassment which arises in connection with popular government is due to the disinclination of parliamentary bodies to arrive at final decisions. There comes a point in all public affairs when deliberation must be brought to a close. It not unfrequently occurs that an imperfect decision is better than no decision at all. This

is a truth which small men never learn, and which men of a broader pattern are frequently slow in learning, and it is wise that the rules adopted by the parliamentary body for the conduct of its business should hold in mind the necessity of directing debate to the questions that are in reality important. A supplemental budget is at best a budget that pertains to five or six months; and there is great danger, should the relative merits of the several services for which money is appropriated be brought into controversy, that the time necessary for making proper provision for the ensuing year, or of considering questions of enduring importance, will be consumed in a discussion of a relatively unimportant question. It is much better that the information derived from a presentation of the necessity of supplemental appropriations should be made a basis for the discussion of the next annual appropriation bill.

32. Deficiency Bills or Supplementary Credits.—The procedure which comes into contrast with that of supplemental budgets, and which under one name or another finds general support in the practice of nations, is known in this country as the voting of "deficiency bills." The corresponding phrase in England is "supplemental credits," in France "*crédit additionnel*." The difference between the supplemental credit and the supplemental budget may be clearly stated. The latter is in reality a new law; the former, while it may have the appearance of a new law, goes no further than to increase an appropriation for an approved service. The original law continues to be the authoritative act, and the supplemental credit does not in any way modify the terms of the original grant. The supplemental budget has the practical effect of establishing a fiscal period of six months, while the supplemental credit recognises the year as the fiscal period, and aims only to supplement appropriations that experience has shown to have been too small as provided for in the original law.

The contrast between these two methods of harmonizing discrepancies is thus clear and distinct; and, assuming the necessity of some sort of corrective legislation, if we are right in withholding our approval from the supplemental budget because it disturbs unnecessarily the stability of conditions essential to the satisfactory administration of a public service, we are forced to approve supplemental credits, since by means of them provision can be made for a service that has run short

of funds without embarrassment to the service itself. If it be urged as against this conclusion that the deficit which is the occasion of the supplemental credit is not due to an erroneous estimate, but to mismanagement on the part of the administration, and that the legislature should, on this account, revise the conditions upon which the grant was originally made, two replies present themselves.

First Responsibility for mismanagement on the part of the executive officers lies with the head of the executive department, and not with the legislature. It is not reasonable to assume that the entire administration is guilty of weak and inefficient management, or that such weakness and inefficiency as it shows has sprung up since the vote of the annual budget. The personnel of the administration is, in the main, the same as when, six months before, the appropriations were voted by the legislature, or when, twelve months before, the estimates were submitted by the administration. It may be that a deficit in some few cases is due to the mismanagement of some particular officers, but this is a matter which properly comes under the jurisdiction of the head of the executive department in which the mismanagement has occurred.

Second Questions of procedure in matters of government must be decided according to the relative advantage or disadvantage likely to follow from them, and should it be true that a mid-year examination of appropriations in process of execution should disclose some error in judgment, either in the policy underlying a service or in the conditions imposed by the law providing for the service, it is probable that less harm would be done by perpetuating the error for five or six months than by an attempt to correct it by new legislation. As an exception to a prescribed rule, and to meet an especially flagrant case, the legislature might perhaps change the conditions of the original grant; but to do this for any considerable number of services, or under circumstances likely to invite extended discussion or party controversy, would, for the reasons already stated, be the occasion of unnecessary embarrassment to the orderly execution of the laws. It is a rule that admits of few exceptions that mid-year fiscal legislation ought to be strictly confined to the voting of supplemental grants to established services.

While approving in a general way the policy of deficiency

bills or supplemental grants, it cannot be overlooked that their use has frequently been attended with serious mischiefs. They seem to present a temptation peculiarly their own. Thus the practice of deficiency bills tempts the administration to withhold a complete statement of its needs in the original estimate for fear its estimates may be cut down. The officers of the executive department may have greater confidence in the willingness of the legislature (or, what amounts to the same thing, in their ability to coerce the legislature) to grant supplemental credits than to vote the entire amount which they recognise as necessary in the original appropriation. This of course is an improper method of procedure and a perversion of the theory of deficiency bills, which should be strictly limited to the correction of legitimate or inevitable errors in the original estimates. The legislature, also, or rather the party in power finds itself exposed to a similar temptation. Suppose, for example, an important election between the voting of the original appropriation and the time when deficiency bills are presented. What is to hinder the legislature from curtailing the appropriations in the regular budget in order to make a show of economy before the public? Such a policy must of course be followed by unusual appropriations in the form of deficiency bills, but the election meantime has taken place and the party has been returned to power. This is both an undignified and a dishonest procedure. It is a falsification of accounts. It is legislation designed to mislead the public. It is morally as culpable as erroneous charges in the accounts of a corporation. But, unfortunately, it is not so regarded in the moral code of practical politics. For a false estimate by the administration the legislature has a quick remedy. The administration is dependent upon the legislature, and there are many ways by which disapproval of such a course may be expressed. For a false estimate by the legislature itself, however, there is no redress except it lie in the vigilance of the party out of power. The true remedy is in a clear appreciation of what a deficiency bill is for and in prescribing such rules that supplemental appropriations will be confined to their legitimate purpose.

33. Administrative Appropriations.—The peculiar temptations that accompany the use of deficiency bills have led to

the suggestion that possibly the administration, acting for the legislature under conditions which would eventually bring its decisions to the legislature for approval and legalization, should be authorized to make provision for the covering of orderly mid-year deficits. This thought suggests three methods of procedure, each of which is practised to some extent by modern peoples.

First The administration may be authorized to extend grants for approved services

Second. The administration may be authorized to transfer the surplus of one service to cover the deficit of another

Third The administration may have at its disposal a limited fund to be used at its discretion

We shall consider, in a cursory manner, each of these suggestions

(1) *Extension of Grants*—Like so many questions in finance, the decision of this one turns upon the extent to which constitutional checks other than those implied in the right of the representatives of the people to vote public moneys have been developed. Parliamentary adjustments are a means to an end, they are not themselves an end. And if no danger to political liberty lies in an extension of the functions of the administration it will, as a rule, lead to increased efficiency in public affairs. Especially is this true when details rather than principles are the subject of consideration. Now it must be remembered that the development of budgets and of budgetary control resulted from a struggle of the people against the arbitrary exactions of an ambitious monarchy. That controversy, however, has been settled. The danger to which popular government is now exposed arises from deceptions practised by legislators rather than encroachments designed by administrators. Moreover, the weakness of popular government shows itself in the inefficiency of administration, due in large measure to the petty limitations under which executive services are performed. The policy of supplemental credits was preferred to that of the supplemental budget because the former grants freer play to administrative control. The same consideration now leads to the approval of the policy of covering deficits in current appropriations by imposing this task upon the administration, provided this can be done

without endangering the supremacy of the legislature in matters of general policy

In no country has this question been so thoroughly discussed as in France, and it may be well on that account to inquire what decision the French have arrived at respecting it. Two important laws have been passed since 1870—that is to say, since the establishment of the present French Republic—for the purpose of harmonizing the conflicting interests which arise on account of deficiencies in specific appropriations. The first of these laws was passed in 1871, the second in 1879. The law of 1871 is interesting in that it practically revived the method followed by the government of Louis Philippe and of the Republic of 1848. In order to understand this law it must be remembered that under the Restoration the French budget was almost embryonic, and it was customary to transfer a surplus from one appropriation to cover a deficit in another. Such a practice was, of course, destructive to clearness of accounts and to the efficacy of legislative control. It was for that reason abandoned. According to the law of 1871, the executive was empowered to extend an appropriation which had been specifically voted, but certain checks were established to prevent the extravagant employment of this unusual power. Thus all moneys spent without the authority of specific grants must, in the first place, be for the support of a service which has already received the approval of the Chambers, it must, in the second place, receive the unanimous approval of the cabinet; and it must, in the third place, be reported as a special item for legalization by the Chambers.

The law of 1879 differed from that of 1871 in that it established yet more stringent checks upon executive appropriations. According to this law, a distinction was made between supplemental and extraordinary expenditures, the first, or supplemental expenditures, being those required for the purpose of completing any work already sanctioned by the Chambers, while extraordinary expenditures are such as pertain to some service not yet authorized by law. They are extraordinary in the sense that the service which they are designed to support has not yet been legalized. They have to do with the opening of a new service. Extraordinary expenditures upon the authority of the cabinet were interdicted, while supple-

mental expenditures were allowed. In addition to the three checks reenacted from the law of 1871 it was further provided that the exercise of this unusual authority by the cabinet should be strictly limited to the prorogation of the Chambers, no money could be expended upon the authority of the cabinet during their dissolution. Such seems to be the settled practice of the French people

It must not be supposed that the French make no use of supplemental credits. Not only do they use them, but they abuse them to such an extent that the outside observer queries whether it might not be well should their admirably devised system of executive appropriations be extended so as to cover most, if not all, of the deficits in specific grants. It must be remembered that France is not well settled in the ways of responsible government, and possibly the adjustment that has been described but foreshadows the direction of future development

In England there is no formal provision for executive appropriations, and it would perhaps be technically correct to say that they do not exist, still no ministry would hesitate to assume the responsibility of providing for an approved service should it become necessary to do so. This is a part of the practical working of cabinet government under conditions of strict responsibility. In the United States, on the other hand, the executive not being a responsible body in the political sense of that phrase, no natural evolution of executive appropriations is possible. On several occasions an executive officer has made use of his personal credit for tiding over a service until such time as provision could be made for it by means of an urgency deficiency bill. This was done, for example, in the case of the Tenth Census, the superintendent assuming personal responsibility for the payment of debts contracted for carrying on the work. Such a practice, however, has never proceeded far enough to result in a precedent in its favour

It is perhaps unnecessary to discuss the merits of a plan so little likely to receive approval as that of the substitution of executive appropriations for supplemental credits. The legislature is in the saddle and is likely to stay there. The situation, however, is by no means satisfactory. Whether one contemplates the abuses of deficiency bills, or seeks to discover

the cause of administrative weakness in popular government, he is forced by the logic of the situation to assert that a carefully expressed law by which the duty is imposed upon the administration of determining when an extension of an appropriation is necessary, and what amount of additional credit is needed in order to carry a service to the close of the fiscal year, does not lie without the field of reasonable discussion. It is probable that such a provision would be followed by two results, both of which approve themselves to the Science of Finance. It would induce greater care in the expenditure of money; it would also induce greater care in the original estimates and in the original vote. The legislature is careless in the matter of appropriations because it knows corrective legislation is sure to follow, executive officers are extravagant (especially the heads of the minor bureaus) because they too often measure their importance by the amount of money they are able to spend. The policy of executive appropriations would tend to change the test of success in administration from extravagance to economy, since the necessity of a supplemental credit under the conditions assumed would be a criticism rather than a commendation. But this suggestion has perhaps been sufficiently extended to make clear the tendencies which it involves.

(2) *Transfer of Credits*—The practice of transferring credits from one appropriation to another, or of borrowing from a fund that shows a surplus to supply a deficit in another, or of arresting the expenditure of money assigned to one service to secure funds for carrying on another, need not claim an extended consideration. It is a practice that has been resorted to more or less by all peoples when financially hard pressed, but the longer their experience in the school of practical financial administration the more decided is their opposition to it. The development of executive appropriations in France, referred to above, was in large measure the result of a series of abuses arising from the practice of transferring credits, and it is only necessary to examine the finances of the municipalities in the United States to secure forcible illustrations of the mischiefs that follow the policy of special funds and the practice of debits and credits between them.

It should, perhaps, be sufficient to urge against this prac-

tice that a transfer from one credit to another undoes the work that it is designed a well-framed budget should perform. The law assigns a specific sum to a specific service, and should the administration be permitted to change the grant it might in an almost imperceptible manner change or radically modify the policy formally expressed in the appropriation bills. The advocacy of executive appropriations cannot extend beyond the correction of legitimate errors in estimates for an approved service; to go further than this would be to clothe the executive department with legislative authority.

Not only does the transfer of credits impair legislative control, but such a policy lends itself readily to deception and is sure to result in confusion. There would be no guarantee that the budget as voted reflects the true opinion of the legislature. Even appropriation bills may be "doctored" for political purposes. In the case of deficiency bills, which, as already explained, invite to deception on the part of the legislature, there is yet the safeguard of simplicity in accounts and of an undivided responsibility; but the practice permitting the administration to transfer credits from one service to another would tend to conceal the issue by leading to confusion of accounts, and to impair responsibility by assigning the same duty to two independent departments of government. Moreover, this practice implies the existence of separate funds which possess a sort of fiscal personality, since there could not otherwise be any debit and credit between them. For reasons that cannot be here presented, since the subject pertains to financial organization rather than financial legislation, the maintenance of any considerable number of independent funds cannot be approved. It is much better to pass all moneys to the consolidated fund from which moneys are paid to specific services on properly attested warrants. Our conclusion, then, is that of the policy of transferring credits, whether by legislative or administrative authority, cannot be seriously considered in the present stage of constitutional development and of financial organization.

(3) *Indefinite Appropriations.*—The third suggestion for covering deficits in specific appropriations through the agency of the executive rather than the administrative authority consists in placing at the disposal of the administration a limited amount of money that may be used at its discretion. This

practice is properly regarded as a form of executive appropriations. Its peculiar characteristic is made clear when it is observed that the extent to which moneys may be expended upon the authority of the government is limited by the amount which the legislature sees fit to place at its disposal for this purpose. The idea is well exemplified by the established practice of the English people.

Recognising the necessity of granting some discretion to a government in the expenditure of public moneys, three funds are placed at the disposal of the government, which may be drawn upon without specific authority, but under conditions of strict responsibility. These are the Treasury Chest fund, the Civil Contingency fund, and the Secret Service fund.*

This is certainly a sensible and safe method of procedure, and commends itself as a simple means of doing away with the necessity of any very extended use of supplementary credits. As a safeguard against the abuse of indefinite appropriations the English Parliament has established a public committee on accounts. This committee guards carefully all specific appropriations, and one of its duties is to see that the government does not make an unwarranted use of moneys placed at its disposal. It is illegal for any expenditures to be made except they be charged to some specific appropriation, and the committee is responsible for balancing all accounts. With such a safeguard as this, and with a clearly defined system of bookkeeping, it is difficult to see how serious abuses could arise from the practice of indefinite appropriations.

The final conclusion from this general discussion is that in the adjustment of discrepancies between estimated and executed budgets the best results may be expected from increasing the responsibility of the executive department of government. Both the financial and the administrative interests support this conclusion, and it is believed that in the condition in which constitutional governments find themselves at the present time the constitutional interest is not endangered by limiting the consideration of the legislature to the regular annual budget.

* For a description of these funds see Todd, *Parliamentary Government of England* (Walpole's Edition), Vol. II, pp. 20-23.

CHAPTER V.

FINANCIAL ORGANIZATION AND ADMINISTRATION.

ORGANIZATION OF THE "TREASURY DEPARTMENT."

CONCERNING THE THEORY OF PUBLIC ACCOUNTS.

(1) Comparison of the French and English Methods

(2) Is Public Accounting on the Basis of "Accruals" Practicable?

HOW SHOULD PUBLIC MONEYS BE KEPT?

(1) Practice in England, France, and Germany.

(2) Practice in the United States.

THE reason why it is necessary to include in the Science of Finance a consideration of financial organization and administration was cursorily explained in the analysis introductory to this treatise. It was there shown that the manner in which fiscal laws are administered, and the form of the machinery for their execution, have a direct bearing upon the smooth working of a fiscal policy, and by inference it was suggested that the indirect effects of the management of the public treasury upon the commercial interests of a people should be accepted as among the important tests of successful administration. It is not designed to carry the discussion of the organization and administration of the Treasury Department so far as to enter upon a consideration of rules for the conduct of treasury officials. No one would for a moment question the importance of adequate "rules" or clear "instructions to agents" for the successful management of fiscal affairs; but the limited space at our disposal must confine our attention to the general outlines of the subject, and we shall be obliged to content ourselves with a consideration of the general principles of organization and accounting, and with a general analysis of the relations existing between the Treasury Department and the commercial world.

It may be well at the outset to notice that, although fiscal operations are, for the most part, non-commercial in character, they nevertheless make use of commercial machinery, and that in this manner the Treasury Department comes into close touch with business affairs. The checks and drafts of public officers, for example, are included among the credits that flow daily through the clearing-houses of the country. Public bonds are quoted side by side with the obligations of corporations and are bought and sold in open market. The warrants and certificates of indebtedness of the various grades of government may be used for investment or for security, in the same manner as ordinary commercial paper. Moreover, in the collection of its taxes or in the disbursement of its funds the government is obliged to make use of the currency of the land, and on this account it is easy to see how mismanagement on the part of treasury officers might seriously embarrass trade and industry. The public treasury cannot withdraw itself from the current of commercial influences should it so desire, and for this reason it is vital to commercial interests that great care should be exercised in formulating the rules by which its fiscal operations are conducted.

34. Organization of the Treasury Department. — No government has ever been able to maintain in the organization of its executive departments a carefully considered and scientific classification of executive functions, and for this reason it is not possible to submit a formal definition of a Treasury Department which properly represents prevalent practice. Speaking in a general way, the Treasury Department is that branch of the executive organization that has to do in a formal and authoritative manner with the financial operations of government. The officers of other departments may handle public moneys, but they do so under rules prescribed by the Treasury Department, and are personally, though not officially, responsible for the observance of those rules. All dues to the government are covered into the Treasury by the use of a receipt to whomsoever pays the money, and all payments are made upon the authority of treasury officials by duly attested warrants. This rule applies to receipts and expenditures of semi-commercial services, as well as to receipts from taxes and expenditures for services that are general in character. In the German states, for

example, the operating expenses for railways, telegraphs, public mines, and public forests are to be found in the official statement of treasury expenditures. In this country the payments and receipts of the post-office must pass through the books of the Treasury Department. The English Exchequer is defined in Palgrave's *Dictionary of Political Economy* as the purse of the nation, and this phrase fairly represents the position which the Treasury Department holds among the executive departments of the State.

Although many differences present themselves in matters of detail, the Treasury Department of every nation must make provision, in one form or another, for the performance of three sets of duties: it must provide for administration within the limits of its own peculiar duties, for adjudication upon all pecuniary claims, and for the keeping of the public accounts. This may be made clear by a cursory description of the Treasury Department of the United States Government, and for the purpose of bringing the entire organization within the scope of a single exhibit this description will be introduced by a formal analysis of the department as at present organized.

ANALYSIS OF THE UNITED STATES TREASURY DEPARTMENT.

I. ADMINISTRATION.—The Secretary of the Treasury, who is the representative of the Treasury Department in the President's cabinet, is personally responsible for the administration of the department. The administrative functions are assigned to officers or offices as follows.

1. First Assistant Secretary, who is made responsible for the following division of services:

- a. Public moneys
- b. Revenue marine.
- c. Stationery, printing, and blanks.
- d. Loans and currency.
- e. Bureau of Engraving and Printing.
- f. Bureau of the Mint.

2. Second Assistant Secretary, who is made responsible to the Secretary for the following division of services:

- a. Special agents
- b. Internal revenue and navigation.
- c. Warrants, estimates, and appropriations.

- d. Office of the Supervising Architect.
- e. Office of the Supervising Surgeon-General of Marine Hospitals
- f. Bureau of Statistics.
- g. Office of Supervising Inspector-General of Steamboats
- 3. The chief clerk, who is responsible for grounds and buildings, for the contingent expenses of the Treasury Department, for the handling of the mail of the department, for the compilation of digests of circulars, and other similar duties
- 4. The Secretary of the Treasury in his capacity of Commissioner of Customs.
- 5. The Commissioner of Internal Revenue
- 6. The Comptroller of the Currency.
- 7. Miscellaneous bureaus which report directly to the Secretary of the Treasury

II AN EXAMINATION OF ACCOUNTS AND ADJUDICATION OF CLAIMS—The Comptroller of the Treasury, who is the judicial though not the administrative head of the Division of Accounts, renders decisions upon claims and accounts which are final so far as the Treasury Department is concerned. The work of examination is assigned to six auditors, as follows.

The First Auditor, who reviews the accounts of the Treasury Department.

The Second Auditor, who reviews the accounts of the War Department.

The Third Auditor, who reviews the accounts of the Interior Department.

The Fourth Auditor, who reviews the accounts of the Navy Department

The Fifth Auditor, who reviews the accounts of the State Department and some other accounts

The Sixth Auditor, who reviews the accounts of the Post-office Department

III THE BUSINESS OPERATIONS OF THE TREASURY DEPARTMENT are intrusted to two officers.

1. The Treasurer of the United States, who is the fiscal agent of the department

2. The Register of the Treasury, who is the bookkeeper of the department

This cursory analysis of the organization of the Treasury Department shows fairly well the manner in which its work

is carried on. The Secretary, and the heads of most of the important bureaus or offices which in the practice of the United States are regarded as political, are changed from administration to administration. It would seem that this practice might prevent a continuous policy in the orderly routine of business, but as a matter of fact precedents are easily established and fairly well observed. The Secretary has large discretionary powers in the administration of his department; and, although his nomination by the President must be concurred in by the Senate, when once appointed he is responsible to the President alone, except he be guilty of some malfeasance of so grave a nature as to warrant impeachment. It would be difficult to imagine a more highly centralized organization than the Treasury Department of the United States, or of a position which imposes greater personal responsibility than is imposed upon the Secretary of the Treasury, and it is not improbable such excellence of administration as the history of this department discloses is in large measure due to this fact.

It will be observed from the above analysis that the Secretary of the Treasury is spoken of as the Commissioner of Customs. There is no legal warrant for this expression. Until 1894 there was an officer known as Commissioner of Customs, whose duties, however, pertained to those of a comptroller rather than those of an administrator. The practice is for the Secretary to exercise personal supervision over collection of customs duties. He performs the duties which the Commissioner of Internal Revenue performs with regard to excise and internal duties. So important is the administration of the customs laws that it seemed proper to recognise the function as a distinct office.

The Comptroller of the Currency, who has general administrative jurisdiction over the national banking system, is properly classed among the administrative officers of the Treasury Department. It is true that many of the duties he is called upon to perform are semi-judicial in character, but it must be remembered that the word adjudication when used in connection with the organization of the Treasury Department is strictly confined to the adjudication of accounts.

Among the miscellaneous bureaus which report directly to the Secretary may be mentioned the Lighthouse Establish-

ment, Life-saving Service, and the Coast and Geodetic Survey

Previous to 1894 the accounting division of the Treasury Department was a complex and somewhat cumbersome affair. It embraced six auditors and three comptrollers, and it was the theory of the department that every claim or account should be examined both by the auditors and by the comptrollers. By an Act of July 31, 1894, the offices of the second comptroller and of the Commissioner of Customs, who, by the analogy of the duties imposed upon him, should have been called the third comptroller, were abolished, and the first comptroller was made the sole comptroller of the Treasury Department. The object of this change was to secure greater expedition in the settlement of claims, and to centralize responsibility for the adjustment of accounts and for the proper interpretation of laws providing for expenditure. Under the present practice the decision of an auditor is accepted as final, except the claimant make appeal to the comptroller, or except the comptroller himself has reason to believe that the audit is for any reason unsatisfactory. The decision upon the legality of a claim lies now, as formerly, with the comptroller, and it is in the comptroller's office, also, that the authoritative account is kept with the appropriations made by Congress. The books of the comptroller open a credit with every department, bureau, or service immediately upon the passage of appropriation bills. The comptroller then notifies the officer in charge of the several departments or bureaus of the amount which Congress has placed at its disposal. All warrants for the payment of moneys from these appropriations, when duly attested, are debited to the appropriation, and it is one of the responsibilities assumed by the comptroller that the warrants issued shall in no case exceed the appropriation. Speaking concisely, therefore, the auditors are responsible for the examination of accounts and claims which in any way involve the payment of public moneys; the comptroller is responsible for the proper interpretation of the law authorizing the payment, for the assignment of the payment to the proper appropriation, and for limiting the payments for any service to the moneys appropriated.

All payments of money must be made by warrants drawn by the Secretary of the Treasury, which warrants must be

countersigned by the Comptroller of the Treasury. These warrants are of two classes. The first, which are called "countable warrants," are addressed to the Treasurer of the United States, directing him to pay money to the disbursing officers of the various departments. These warrants are based upon requests from the heads of departments having charge of services for which moneys have been appropriated. The payment of moneys due individuals is made by the disbursing officers of the bureaus or departments. It may be in the form of cash, of a check or draft against a private deposit, or, under some conditions, of a draft drawn on the Treasurer of the United States. The second class of warrants, which are called "statement warrants," are drawn in favour of individuals, corporations, firms, etc., and are issued in satisfaction of services rendered or of other miscellaneous demands. In this case the payment is commonly made in the form of a draft on the Treasurer of the United States.

The office of Treasurer of the United States was established by an Act of Congress September 2, 1789. His duties, while of a varied character, are in the main those of a receiving and disbursing officer of a corporation. He is the agent of the United States for the issue of United States notes, for the redemption of the notes of national banks, and for the payment of interest on the public debt. He receives the deposit of bonds used by the national banks as security for their circulation or as security for public moneys deposited with them. He is the custodian of most of the trust funds, such as the Pacific Railroad Sinking Fund and the Indian Trusts. He is also the collector of the tax imposed upon the national banks.

It is through the Treasurer that the receipts of all moneys from customs duties, internal revenue, sales of land, and miscellaneous sources are "covered" into the Treasury. Upon the receipt of money by any officer or agent authorized to receive the same a certificate of deposit is issued in favour of him who makes the payment. This certificate is commonly issued in duplicate, one copy of which is forwarded to the Secretary of the Treasury, who issues a warrant covering the amount into the Treasury. It is not until this warrant is issued that the money is available for the payment of appropriations. It thus appears that moneys covered into the

Treasury, as well as moneys paid out of the Treasury, are upon warrants issued by the Secretary of the Treasury.

The office of Register of the Treasury was established at the same time as that of the Treasurer. He is the public bookkeeper for the cash account, as the comptroller is the public bookkeeper for the appropriations. He also has charge of the official records of the Treasury Department, and as such is called upon to perform many various and dissimilar duties.

It is evident from the foregoing survey that while the assignment of duties and functions may have been more or less accidental (as most of the critics of the organization of the Treasury Department aver) no pecuniary claim can be paid without careful scrutiny, and that the general operations of the Treasury Department are such as to guarantee that the moneys appropriated by Congress will be expended as Congress intended. The method of procedure is simple. The duties assigned to the many officials are clearly expressed, and, in the main, experience justifies the confidence which the public has in the administration of the Treasury Department. Doubtless there are imperfections, but these may be left for the correction of those intrusted with the treasury management when such imperfections do as a matter of fact embarrass the operations of the department. Since it is not our intention to consider this question in detail, it will not be necessary to present the corresponding organization for the management of fiscal affairs in other countries. In one way or another they all secure the same general results. The above analysis was presented in order to leave upon the mind of the student the impression that the financial operations of the government are in all particulars subject to the same necessities as the organization for the financial administration of a business or a corporation.

From the care which the Treasury Department takes in providing against false claims, and for establishing checks against the illegal expenditure of moneys, it would seem that no further attention need be given to the matter by any of the other departments of government; and, for the most part, such is the settled practice in this country. An individual has, of course, the right of appeal to the Court of Claims, this being the court provided by the government in which suits against itself may be tried; nor is it an uncommon thing for

the treasury officials themselves to cause a case to be brought in the Court of Claims so that the decision may be final in its character. Moreover, an individual has always open to him the right of petition to Congress against an improper decision of the Treasury Department. To this extent the settlement of accounts in the Treasury Department is subject to revision; and, although the right of petition is frequently abused, it would be unwise to deny or to curtail it, for it serves as a wholesome check on what might otherwise become an arbitrary and unwarranted adjustment of private claims.

As between the Treasury Department and the other departments of government it is now pretty well settled that the Secretary of the Treasury has exclusive jurisdiction. The case that led to a definite law upon this point arose when Mr Stanton was Secretary of War.* In September, 1866, the Attorney-General gave an opinion "that he [the Secretary of War] had authority to withhold his signature from the requisition for an amount which he believed to be not properly due, though certified to by the accounting officers of the Treasury Department." Acting upon this opinion, Mr Stanton refused to make requisitions for amounts in excess of what he believed to be due, although the amounts had been duly allowed. The issue thus raised led to considerable discussion, which was finally settled by the Act of March 2, 1868, which asserted that the Treasury Department has final jurisdiction over accounts, subject only to revision by Congress or in the proper court. It is difficult to see how any other decision could have been arrived at without bringing the accounts of the government into inextricable confusion.

The success of the plan of giving the Treasury Department such extended control over the settlement of accounts is attested by the fact that the House of Representatives has not seen fit to continue its experiment with what perhaps may be termed a legislative auditing committee. In 1814 the House created a Committee on Public Expenditures,† whose duty it was to "examine into the state of the several public depart-

* Authority for this statement is Bolles, *Financial History of the United States*, 1861-1885.

† The duties of this committee had been performed by the Committee of Ways and Means from 1802 to 1814.

ments, and particularly into the laws making appropriations of money, and to report whether the moneys have been distributed conformably with such laws, also to report from time to time such provisions and arrangements as may be necessary to add to the economy of the departments and the accountability of their officers" * The practice of maintaining a legislative auditing committee is quite general in one form or another among Continental governments, but it does not seem to fit into the general scheme of a government of divided functions, like that of the United States. The auditing of accounts is strictly administrative in character, and, provided the legislature exercise care respecting the form in which current reports are issued, it is believed that better results will follow the assignment of this duty to the Treasury Department. This does not mean that treasury officials are superior to investigation, for Congress always has the right of calling for special reports or of sending a committee for special investigation, and this is a right frequently exercised in the United States. The treasury officials feel that they may be subjected to an investigation at a moment's notice, and it must be that this fact exercises a wholesome influence upon the manner in which they conduct their respective offices.

35. Concerning the Theory of Public Accounting—Of greater importance is the question respecting the theory of accounts to which the books of the public treasury are adjusted. This has little to do with what is ordinarily called "bookkeeping," and, so far as the methods of entry are concerned, or the form in which blanks are drawn, or the wording of receipts and warrants, or other similar details, the experience of the officials charged with the work may be relied upon for appropriate results. It is a matter of scientific interest, however, to inquire what conception may with propriety be accepted as the basis of the accounting system. Two methods of accounting present themselves for approval: the one asserts that accounts should be kept on the basis of accrued assets and accrued liabilities; the other presents cash receipts and cash expenditures as the more appropriate basis of accounting. The first of these methods is followed by France, the second by England and the United States.

* Quoted from Adams, *The Control of the Purse*, p. 218.

(1) *Comparison of the French and English Methods.*—The significant feature of the French method of accounting is, to employ Bastable's phrase, that "the financial year is invested with a kind of personality." * Instead of recording the actual receipts and actual expenditures of a definite period and accepting this statement as a final financial report they assign to a year whatever income springs from the laws in force during the year, whether this income is covered into the treasury during the year or not, they charge also to the year all expenditures that arise on account of appropriations for the year, whether the accounts are settled and paid within the year or not. It is impossible under this method to close the accounts of any particular year until some time after the year itself is passed. This method of accounting is what is known in the language of French finance as the "*exercice financier*" as contrasted with the "*gestion annuelle*" The account is kept with the execution of laws, rather than with the cash transactions of the treasury

The claim made for this method of accounting is that, although the result at which it arrives may be delayed, it is nevertheless accurate. It does not permit an expenditure incurred during one year to be charged to the year following; nor does it allow that delinquency in the payment of taxes should result in decreasing the income of the current year to the advantage of the year following. It is the design of such bookkeeping to show the financial standing of the government as affected by the operations of the year, and this it does by striking a balance between the assets that have *accrued* during the year and the liabilities that have *accrued* during the same period, and for this reason are properly charged to the assets

The significant feature of the English system, on the other hand, is that immediately upon the close of the fiscal year the Treasury Department counts its cash. It sets down what has been received and what has been expended during the twelve months, and if receipts plus the balance on hand at the beginning of the year, reduced by the amount of formal payments, equal the cash on hand, the fact is accepted as proof that the accounts are correct. No notice is taken of the fact that part of the moneys received during the year become assets to the

* Cf. Bastable, *Public Finance*, p. 703.

government on account of the operations of laws during the previous year, or that part of the moneys paid were to satisfy debts left over from the year before. Only upon the assumption that the credits and obligations that the current year take over from the year previous are about equal to the credits and liabilities passed over to the year following can it be said that a cash statement presents a true idea of the financial standing of the nation; and, even admitting this assumption, it cannot be denied that the cash statement destroys the significance of the fiscal period, since it includes the results of operations that did not take place within the period for which it pretends to report.

An English writer thus expresses the difference between the English and the French system of government accounts, and although he wrote in 1866 his statement represents fairly well the present situation, except so far as certain minor details are concerned. His statement is as follows:

“The French budget attempts three things which the English does not. (1) First, it takes up what we may call the real revenue of each year and the real expenses of each year. The English system is very rough. We only regard (technicalities apart) what revenue is received at the head treasury during the year, and what money has been issued from the head treasury for services and payments during it. It is in principle a cash account of income and a cash account of outgoing. But the French are more elaborate. They impose a certain set of taxes for the year, but the whole of these taxes may not come to hand for months after the year. Our income tax, as every one knows, is very often months in arrear, and it is so with many taxes in all countries. Credits, for example, are given (like our malt credits) to various taxpayers, who are not expected to pay, and do not pay, till that credit is expired. Now all such outlying moneys, say of the year 1866, the French financiers treat as belonging to the year 1866; they are not, indeed, received during it, but still they belong to it. Some one, during 1866, became liable to pay, either at the time or hereafter, those sums, and so the State got richer. Just so on the other side of the account. Liabilities may have been incurred by the State for work done during the year, and those debts to pay are to be reckoned against the debts to come in. (2) And again, the French financier follows the expenditure

to subordinate dispensers. Although the money may have been drawn from the head treasury, it may be lying in a minor one, and this, if not wanted for a liability of 1866, a French financier would not treat as an outgoing of 1866. Why should he? he would ask. It is a transfer, so to say, of a sum of money from a head office to a branch office. The accounts, therefore, of the Imperial Government resemble nothing so much as the accounts of careful shipowners. In these there are various 'voyages' open at once, and money is not treated as actually expended merely because the captain has drawn for it, the voyage account stands open till all the freight earned has come in, till all the incurred liabilities are discharged, till the captain has accounted for all the money he drew from England and repaid the balance, if any. Substitute the 'exercise' of the year for the voyage of the ship and you have the Paris account-books with 1864, 1865, and 1866 all open at once. (3) Again, the French try to show, not what their casual income and casual outgoing for the year is, but how much of each is due to permanent and how much to temporary causes . . .

"Every one who knows anything of the difficulty of explaining at all effectually even simple matters of accounts will know that such elaborate figures as these can never be understood by many persons, and that even among those persons there are sure to be many wranglers about them . . . The political effect is that the French nation can form no opinion about its finance. It is told too much, and in too abstract a form, and so knows nothing. The English Chancellor gives every year a rough popular account of the general state of things, and this can be broadly criticised and dealt with. And it is only so that a free nation can judge of its finance. If it attempts precision it insures failure" *.

The writer of the above seems to admit that the English cash statement cannot give a correct statement, but he asserts that it is preferable to the French system because it leaves an intelligent impression upon the mind of the ordinary citizen. Mr. Wilson, writing at a much later period, urges the same consideration. He says:

"Under arrangements of this kind [that is, the French

* Quoted from *Journal of the Statistical Society*, 1867, Vol. XXX, p. 171

system of accounting] the greatest confusion may easily prevail, and it is always three or four years before the nation can know what the definitive expenditure of a given year is. Indeed, it is quite possible to hide that important fact from the people altogether. Even in France, with its carefully chosen budget committees, the true state of the national balance-sheet is often hard to discover. Arrears of taxes in one year overlap with those of other years, credits old jostle credits new, and amid the confusion the truth is smothered." *

The comparison thus drawn between the English and the French method of accounting presents a question that must be decided one way or the other, for whatever the decision it will influence the character of public accounts even to their most minute details. In England and the United States all financial statements are based on cash receipts and cash expenditure, or, to be more accurate, upon receipts "covered" into the treasury and upon payments from the treasury as evidenced by the "issue" of duly attested "warrants." Such a statement has the merit of simplicity and of providing a balance with sufficient promptness to be of some importance to the legislative body in its discussion upon financial matters. As we learned when considering the rules for making estimates, the receipts and expenditures of the first three months of a current year are known and are made use of in estimating the probable deficiencies in authorized appropriations, and the probable income and expenditures for the year to be covered by current legislation. While this is undoubtedly a great advantage, it must nevertheless be admitted that a cash statement of receipts and expenditures arbitrarily closed at the expiration of the fiscal year is not, and, from the nature of the case, cannot be, a truthful financial exhibit. The French are certainly right in asserting that the year which is made the unit for a long series of minutely described appropriations does possess a certain personality, and that a much more intelligent appreciation of the character of financial legislation may be obtained if the results of the fiscal legislation of each year are grouped together than if the income and expenditures incident to that year are permitted to overlap and intermingle with the accounts of subsequent years. It seems, then, that each of these methods as practised by the governments in question

* Wilson, *The National Budget*, p. 148.

has its peculiar advantage and its peculiar disadvantage, and on this account the suggestion presents itself whether some means cannot be devised for combining celerity in the closing of accounts and clearness of statement with the preservation of the personality of the fiscal period. To this end it will be necessary to inquire a little more carefully what is implied in the adjustment of an accounting system to the theory of "accruals."

Should we turn our attention from public accounting to the best corporation accounting one will discover that "earnings and expenses" have almost universally supplanted the older bookkeeping phrases of "receipts and expenditures." The idea seems to be that liabilities should be balanced against assets, and not payments out against payments in. The evil of the cash system is that it cannot make a true exhibit of the condition of affairs, because it confines the record to accomplished financial events. It presents no guarantee that a company is solvent even though it shows thousands as cash on hand, for how can one know that obligations that ought to be charged against this balance have been paid? The only way of making an intelligent statement, by which is meant a statement that shows upon its face the standing of the business to which it pertains, is to accept as the basis of the statement assets as accrued and liabilities as accrued at the date of the report.

What, then, is an accrual? By an accrual is meant the size or the amount or the stage of growth of an orderly income or of a constantly accumulating expense. The design of accounting on the basis of accruals is to get at the present worth of assets and the present amount of liabilities at the time a balance is struck. An accrual undertakes to measure the results of a gradual and orderly procedure on both sides of the account, to credit to each month (or period) the earnings of that month, and to charge to that month the expenses incident to the earnings. Should an accountant charge against the earnings of the present month the expenses of the previous month, or should he carry them over into the accounts of the month following, it would be impossible for the management to localize divergencies from the ordinary course of events which in the grand result are responsible for the deficit or for the surplus.

The exact nature of an accrual will be made clear by an illustration. Suppose the government has issued \$10,000,000 in bonds and that the contract calls for quarterly payments of interest, the dates for payments being July 31st, October 31st, January 31st, and April 30th. The fiscal year closes, let us say, June 30th. It is evident that two months will have elapsed since the last payment of interest at the time the treasurer must make up his report. Shall he take any account of the interest that has been growing since April 30th, the date of the last payment, and set it down as a sum for which the government is liable, or shall he ignore this liability and bring it into his accounts for the first time when, a month later, the three months' interest is paid in lump? Bookkeeping on the basis of accruals will charge up the two months' interest as a liability of the year ending June 30th, and this is manifestly where it belongs. To carry it over to the next year would result in burdening that year with a legacy of obligation from which it should be freed. An accrued asset chargeable to a definite period, on the other hand, is the earnings of the industry during the period, and it is the design of bookkeeping according to the theory of accruals to set the liabilities of a definite period against the earnings of the same period.

The following are the advantages of this system of accounting:

It allows a true statement of the operations of the period covered by the report.

It shows the financial standing of the corporation so far as affected by the operations of a definite period.

It permits the localization of any particular influence by which operations are affected.

It permits a quicker and more accurate determination of the influences at work during any particular period.

(2) *Is Public Accounting on the Basis of Accruals Practicable?*—It must certainly be admitted that accounting on the basis of accruals is a refinement upon the simple cash balance. Can it be applied to public accounting?

Without expressing a positive opinion upon this point, it is difficult to say why government accounting cannot be carried on successfully on the basis of accruals. There is nothing in the nature of public expenditures which would render this more difficult for the government than for a railway corpora-

tion The income of government arises from taxes or from services Taxes are an asset to the State when legally assessed, while the earnings from a public service are in all respects like the earnings of the private corporation There is no more difficulty in reporting customs duties accrued from day to day than in reporting moneys received from day to day Internal revenue, also, being an excise duty, grows from day to day with the process of manufacture, and reports might be made by internal revenue officers at sufficiently frequent intervals to enable the treasurer to maintain a current oversight over public assets from this source The assessment or apportionment of direct or property taxes, it is true, occurs but once a year, but a clearer idea of the business of levying and collecting taxes could be obtained were this amount set up on the books of the State as an asset (deficiencies in collection being accounted for as a corporation accounts for bad debts) than by the present method of taking into consideration nothing but amounts actually paid There is no difficulty in applying the theory of accruals to public income.

The expenditures of the State, also, permit of their being charged when accrued instead of deferring the charge until the payment is actually made The pay-roll of the State is like the pay-roll of a corporation and represents a constantly accruing obligation It is an "operating expense" Interest upon a debt accrues with mathematical precision, and may be taken up on the books without reference to the date of maturity or the time of payment The obligations arising from contracts are perhaps a little more difficult to handle, but the same problem is solved successfully by corporation accountants There is nothing in the nature of public income or of public expenditure to prevent the adjustment of public accounting to the theory of accruals

Why, then, it may be asked, do England and the United States hold to the cash statement for public accounts? Many reasons might be given in explanation of this fact Their contentment with the cruder method of accounting may in part be traceable to the confusion which exists in public finances in France, where it is attempted to realize the theory of accruals But an examination of the subject would show that this confusion is due to the failure of the French people to apply strictly the theory of accruals. Accounts are kept open

unduly long in order that special services may be made the basis of special reports, a practice which is condemned by the theory of accruals as well as by the theory of a cash statement. The accounting system strictly adjusted to the theory of accruals should permit a cross-section to be cut anywhere and at any time in fiscal operations. The French have not worked out the idea which they profess to have accepted. Mr. Wilson's criticism quoted above is sound when addressed to what the French do, but it is not final when addressed to what they might do.

Speaking for our own country, there are two reasons why it would be difficult to secure the adoption of what is here claimed to be the better method of accounting. In the first place, public servants are not accustomed to the discipline essential to secure accurate and prompt returns, and it is not sure that this discipline can be secured until the civil service and tenure in office are more firmly established than at the present time. In the second place, the plan of accounting proposed would require a higher degree of centralization in the administration of public accounts than is provided for by the present organization of the Treasury Department. It has been suggested by some writers that the accounting department of the Federal Government should be a separate and independent department. Without conceding the necessity of so radical a change, it is believed that decided advantage would arise should the duties imposed upon the comptroller's division of the treasury be made more comprehensive. Every disbursing officer and every collecting agent in the land should report to this division; at least such a provision would be necessary if the business of government is to be recorded after the manner of the accounting of the best organized business corporations. The wisdom of undertaking a reform in treasury accounting must be left to the decision of the practical statesman, and he must decide it in view of the shifting character of the civil service and of the popular prejudice against too great centralization in administrative authority.

Much might be learned by a study of the practice of private corporations besides the fact that a balance of assets and liabilities is superior to a balance of receipts and expenditures; but our inquiry in this direction must content itself with a single suggestion. Public accounts make no difference be-

tween expenditures for the support of current services and expenditures that are in the nature of public investments, from which it follows that public accounts do not show how much it costs to run the government. It is not possible in the mixed statements which are presented to the public to find out exactly what the current operating or working expenses are. No great harm arises from this so long as nothing in the nature of commercial enterprises or investments is undertaken by the State. But at present the tendency seems to be toward experimentation with such enterprises, a tendency that shows itself most clearly in the case of municipal corporations. Public water-works, public lighting, and public street railways are growing in favour; and, whatever the final conclusion may be as to the expediency of such investments, it is certain that municipal governments will have more to do with these matters before they have less. If a valuable and permanent lesson is to be learned from these experiments it is essential that the capital account of municipal corporations should be kept separate from the current expenses account. One cannot measure in his imagination the mischiefs that may result from the so-called reports of water-works commissioners, public-lighting commissioners, or street-railway commissioners, which fail to separate operating expenses and expenditures in investment, or which fail to make proper recognition of the depreciation in public property. It is believed that municipal corporations, if not, indeed, all grades of government, should carry their accounting so far as to declare a balance-sheet from year to year, a consideration of this point, however, would carry us too far from the main line of our discussion.

The impression left by this cursory consideration is that in no particular does government so much resemble a business as in the matter of its accounts. True accounting rests upon scientific classification, and, while public officials ought perhaps to take the lead in the development of conclusive and authoritative bookkeeping, the fact is that the organization of government for the purpose of auditing accounts is, in this country at least, unscientific, and the classifications which have been adopted are inadequate when compared with the best accounting of the most progressive corporations. This remark is more pertinent when addressed to the bookkeeping

of municipalities than to that of the Federal Government. But the reports of all grades of government might be made truer, clearer, and more scientific by conformity, so far as possible, to the accounting of the most carefully administered corporation.

36. How should Public Moneys be Kept?—This question, like that of the theory of public accounts, involves broad and comprehensive interests. A general survey of the practice of governments shows two pretty well-defined policies for keeping the funds of imperial or national governments. The question of local or State financial management need not here be considered. The first is illustrated by the practice of England, France, Germany, and, indeed, of most of the European countries, and consists in the establishment of a bank in the management of which the government exercises a directing, if not a controlling, influence, and of which the government makes use in most of its fiscal transactions. The second policy is the one practised by the Federal Government of the United States, and consists in the establishment and exclusive management of an independent treasury. The aim of this policy is to separate the transactions of the State from commercial transactions. With this end in view the government provides its own vaults for the safe keeping of its funds, covers the money which it receives by receipts which it issues to its own officers, and distributes its funds by drafts and checks which it draws against itself.

It is manifest that the appropriate method of keeping public funds should be determined in view of two quite distinct interests. On the one hand, the government must be guaranteed the safety of its funds, and provide for their disposal in such a manner that they may be employed with convenience and despatch, on the other hand, inasmuch as the government makes use in its exchanges of the same medium of payment as individuals, and since the transactions of the government are greater than those of any other single corporation or business, it is essential that these transactions should be carried on in such a manner that the quantity of money in circulation should not, on their account, be subjected to sudden and arbitrary fluctuations. The significance of this latter requirement will be appreciated if the amount of annual governmental expenditures be compared with the volume of cur-

rency In the United States, for example, the volume of currency is perhaps \$1,700,000,000, while the public expenditures, all grades of government being taken into consideration, are slightly under \$1,000,000,000 Should, now, the public income be in excess of public expenditures, or should income and expenditure be so adjusted that the latter follows tardily upon the former, it is evident that the volume of currency in circulation might be so far reduced as to seriously embarrass the orderly payments of commerce It might, to use the common phrase, produce a stringency in the money market.

This danger of a monetary stringency is increased by the fact that a commercial demand for money is not the same for all times of the year, and should it happen that a surplus in public revenue takes place at a period of unusual commercial demand the business world would feel the pressure, although the amount locked up in the public treasury were comparatively small It thus appears that the question which asks how a government should keep its funds is one that demands broad and comprehensive commercial considerations, as well as a consideration of the safety and convenience in public transactions.

(1) *Practice in England, France, and Germany*—As already remarked, most of the European states solve this problem by the establishment of a national bank Speaking generally, and without any particular banking institution in mind, a national bank is an institution which, in return for some special privileges granted by the government, agrees to become the custodian of the public funds, and to serve as the fiscal agent of the State in formal business transactions In England, for example, all public moneys received from taxes are paid into the Bank of England or of Ireland, and credited to the account of the public exchequer The bank transacts the entire business of the government “She acts not only,” says Adam Smith, “as an ordinary bank, but as a great engine of State” Accounts and audits are controlled by the government, but the business is transacted over the counter of the bank At the bank, however, the government is on the same footing as other depositors; and, since the money deposited can be loaned out in the ordinary course of business, there is no danger that fluctuations in the receipts and payments of government will occasion a fluctuation in the volume of currency available

exhaust the resources of the bank is met by an order from the government to issue notes for the discount of commercial paper without bullion security. In France there is no limit placed to the issue of notes, and the bank itself determines when unusual issues shall be made. In Germany the situation is practically the same, except that the tax on circulation increases with the size of the issue, a provision which works to limit the amount of notes in circulation to the needs of commerce. It thus becomes clear that for these nations the question of how public moneys are kept is subordinated to the question of the control of the country's circulation; and that, having decided to attain elasticity by a more or less direct regulation of discounts, the entire business operations of the State are brought into as close touch with the commercial world as possible. It is necessary to grasp this fact in order to apprehend the theory upon which the opposing policy of governmental isolation rests, a policy formally adopted by the United States when it established the independent treasury or sub-treasury system.

(2) *Practice in the United States*—It may be well to say a word, by way of a prefatory observation, respecting the manner in which the United States Government kept its funds before the formal establishment of the independent treasury in 1846. The common impression seems to be that during the existence of the first and second national banks^{*} these institutions were made the fiscal agents of the government, receiving its deposits and disbursing its funds. This, however, is an erroneous impression. There is nothing in the charter of the first National Bank which goes to show that it was designed to be the depository of the public funds. This could not have been done had it been regarded as desirable, for communication between the different parts of the country was so difficult and uncertain, and local jealousies were so strong, that a financial institution under the patronage of Congress with branches in all parts of the country would have been an impossibility. Private banks were, therefore, used, and there is no indication that the public bank had precedence over private banks in any matter that pertained to deposits or disbursements. The charter of the second National Bank was drawn with the

* The charter of the first National Bank extended from 1791 to 1811, that of the second National Bank from 1817 to 1837.

idea of securing a centralized control over public deposits; but it was never intended that this institution should have exclusive use of public moneys. Private banks were always used as depositories, but, at first, under rules prescribed by the directors of the National Bank. The difficulties that arose on this account, and which led the bank in 1818 to give notice that it would no longer act as the agent of the government, present considerations too minute for the present broad writing. The significant fact is that the Federal Government tried the experiment of a bank of the European type, so far as that was possible under the conditions which then existed for transportation and communication. The experiment seemed to fail, and for that reason Congress undertook to solve the problem in another way. Provision was made for public deposits by building vaults and establishing sub-treasuries; for collections and disbursements by making use, so far as possible, of its own machinery for the transfer of value; and for an elastic currency either through the agency of State banks, as was the case prior to 1863, or, as at present, by means of a system of national banks. The Government of the United States does not acknowledge its responsibility for providing funds to meet unusual commercial demands. It is its aim rather to keep itself separate from the flurries and panics of the commercial world.

The title of the law which declared the policy of independence is "An Act to provide for the better organization of the Treasury, and for the collection, safe keeping, transfer, and disbursement of the public revenue." The quarrel of President Jackson with the second National Bank, the withdrawal of public deposits from this bank and their distribution to State banks, the consequent expansion of State banking, the increase of speculation, the extension of public improvements under the insane enthusiasm of State governments and private corporations, the commercial panic of 1837 and the banking panic of 1843 which resulted from this unhealthy commercial activity, the losses sustained by the Federal Government through its deposits with State banks, the difficulties encountered by the public treasury on account of the great variety of money offered for the payment of public dues, the embarrassment to business occasioned by the desire of the Federal Government to maintain a specie basis for its receipts and expenditures—

these, and all other facts of that period of commercial disaster and financial disgrace from 1830 to 1845, are well known to the student of American history. The policy of depositing public funds in State banks without the restraining influence of a national bank over their issue of notes, and without adequate provision for the proper use of public funds and their prompt repayment, could no longer be supported by public opinion. On the other hand, so great was popular prejudice against Federal interference with local affairs that it was impossible for the Federal Government to establish a banking institution which should be the exclusive depository of public funds, and which should have adequate power to establish and maintain a uniform currency throughout the United States. It must be understood that the design of the sub-treasury system is the absolute separation of the treasury from business affairs. Not only was the influence of the treasury in commercial affairs regarded with suspicion by the merchants, and the creation of the Federal bank regarded as an encroachment upon the rights of the State by the people, but the Federal Government, on its part, feared to trust its funds to commercial agencies for temporary use lest it should be subjected to loss. In such a state of affairs nothing remained but the establishment of an independent treasury system.

The policy of separating public from private business having been formally established, what can be said of the result? Is it possible for a government which handles from three to four hundred millions of dollars a year, and which is imposed with the duty of providing a circulating medium, to evade the necessity of performing banking functions, even though it refuses to assume responsibility for the administration of a banking corporation? The experience of the United States upon this point will perhaps be more instructive than an attempt at theoretical consideration. Three facts may be noticed as bearing upon this question.

First It was a part of this scheme of separation that the government should employ specie in its own transactions to the exclusion of all other forms of currency. The notes of the State banks were not only unsafe, but they lacked the uniformity of a national currency. The only stable and uniform money was gold and silver; and the government, having transferred to the States all control over banking, chose to confine

itself to that form of money over which, by the Constitution, it was obliged to retain exclusive jurisdiction. This phase of the general policy of treasury isolation was not attended with any marked degree of success. Not only was it impossible for the government to transact its business in conformity with the rules laid down by the "specie circular"; but, in so far as it was able to command specie, it embarrassed the operations of the State banks, which relied upon the fund of specie in the country for their reserves, and rendered them less safe than they otherwise might have been. Dr Colton, writing in 1856, said: "This government institution [the independent treasury], therefore, thus becomes an interfering power with the banking operations of the country to disturb and embarrass them."* We admit this to be a curt disposal of a question which at the time was the subject of extensive discussion and bitter controversy, but the simple fact is that the attempt to separate the fiscal transactions of the Federal Government from the commercial transactions of industry is one that cannot be realized. A sovereign State cannot evade its responsibility for establishing and maintaining a national currency, and any attempt to do so not only occasions loss to itself by its use of local currencies, but it results in general commercial embarrassment.

Second. In the second place, the Federal Government has, contrary to the theory of independence, seen fit to establish a note-issue business, and to this extent has converted the Treasury Department into a banking organization. Reference is here made to the fact that the treasury notes issued during the War of the Rebellion, and which in 1879 were brought to par value with specie by the policy of "resumption," have since then been sustained in circulation by the maintenance in the Treasury Department of a gold reserve. The notes thus sustained constitute twenty per cent of the currency in circulation. To this extent the currency is fixed and inflexible. Whether or not this is wise we shall not undertake to discuss, nor shall we venture to inquire whether the issue of notes can appropriately be undertaken except in connection with the banking functions of exchange and discount, our only point is that in this particular, also, the theory of independence

* Cf. Kinley's *The Independent Treasury of the United States*, p. 37.

does not seem to have sustained itself. The exigencies which the treasury has met have proven stronger than the theory.

Third. Finally, the government, contrary to the theory, has been forced to assume responsibility for the bullion reserve of the country, and by so doing to acknowledge that a country whose commercial life rests on a highly organized system of credits requires of its government that the standard of values upon which credits are based, and in conformity with which contracts are drawn, cannot be a matter of indifference to the State. This duty of guarding the specie reserve is recognised as the most significant, if not the most important, function of a national bank like that of England, of France, or of Germany; and nothing could more clearly indicate the inadequacy of the policy of fiscal isolation than the fact that the United States Government has been forced to assume the task of protecting the bullion reserve of the country against the drains of an adverse trade.

If it be impossible, as the experience of the United States seems to indicate, for a sovereign government to withdraw itself from the circle of commercial interests, it seems wise to conclude that the means for exerting this influence should be direct in order to be effective. The independence of a public treasury is a policy that cannot be maintained except in the most formal and superficial manner.

This discussion has been carried on in view of the responsibilities that necessarily come to a sovereign State; with local governments the situation presents no difficulties. A municipality, a county treasury, or even a State will find that the most convenient method of transacting business will be through the agency of local banks. The experience of business corporations in the disposal of their funds may be accepted as pertinent for minor public corporations. It is the broad commercial policies and monetary problems involved that make this question a serious one for national governments, and with these local governments are not concerned.

PART II.

PUBLIC REVENUE.

PRELIMINARY CHAPTER.

. GENERAL CONSIDERATIONS RESPECTING PUBLIC REVENUE.

CLASSIFICATION OF PUBLIC REVENUE

- (1) Main Divisions
- (2) Comparison of Direct and Derivative Revenue.
- (3) Bequests and Indemnities
- (4) Fees and Assessments
- (5) Revenue from Expropriation
- (6) The Lawyer's Classification

COMPARISON OF PUBLIC AND PRIVATE INDUSTRY.

MARKS OF A GOOD REVENUE SYSTEM.

THE investigation respecting expenditures having been brought to a close, it now becomes our task to consider the nature and the sources of public income, and to search for those administrative rules and general principles by which the necessary revenue of the State may be secured in the manner most advantageous to all interests concerned. The problems of public income naturally classify themselves according to the sources from which this income flows, and on this account a consideration of the possible sources of public revenue will be the most natural and helpful introduction to the discussion of these specific problems

37 Classification of Public Revenue. — (1) *Main Divisions* — The revenue which flows into the treasury of a State is of three sorts. It may be a direct revenue, a derivative

revenue, or an anticipatory revenue By direct revenue is meant all revenue that accrues to the State from public ownership in productive property, or public management of productive industry, or which falls to it by virtue of its sovereign character or corporate personality By derivative revenue is meant revenue which forms in the first instance a part of the income of the citizen, but which is paid by him to the State in satisfaction of some revenue law In this instance the citizen rather than the State is the owner of the property, or the manager of the industry, or the recipient of actual benefices. The distinction between direct and derivative revenue becomes clear when it is noted that direct revenue, so far as it is industrial revenue, constitutes a positive addition to the social income, while derivative revenue, although it augments the income of the State, is in reality a transfer of a part of the earnings of the citizens to the State An analysis of direct revenue leads to a consideration of Public Domain and Public Industries, and of awards and gratuities, an analysis of derivative revenue leads to a study of the nature and principles of Taxation in all of its forms

In addition to direct and derivative revenues the State may secure funds through the use of its credit, that is to say, it may borrow money This revenue is properly characterized as anticipatory revenue It is secured through the creation of a debt, and in any sound system of finance is recognised as the first step toward an increase in taxes or a higher return from public property or public industry Public credit as a source of income to the State cannot be understood except one is familiar with the principles that control direct and derivative revenue Its legitimate use is confined to making headway against a fiscal exigency or to the providing of capital for public investment These are both unusual conditions The advent of an expensive war may constitute a fiscal exigency and justify the use of public credit The policy of building a great system of canals or railways may be accepted as an example of what is meant by the investment of public capital, and the capital for investment will in all probability be secured by the sale of bonds In both classes of cases the occasion of the expenditure is out of the ordinary In neither is the revenue secured a final revenue, but carries with it the necessity of securing an equal amount at some time in the future with which

to pay back the money borrowed. It is thus evident that anticipatory revenue is different in its nature and its use from orderly revenue, and that for this reason it should receive separate consideration.

The advantage of a separate study of public credit is emphasized when it is seen that the principles which properly dominate the administration of public finance in ordinary times and for orderly and continuously recurring expenditures, are not, in all respects, the principles to which the public treasury should be adjusted in times of fiscal exigency, or when for any reason unusual expenditures are to be made. To put the case concisely, there is a system of orderly financing and a system of exigency and investment financing, each of which is subject to its own peculiar principles so far as income is concerned. In this fact is found a second reason for a separate treatment of public credit.

The foregoing analysis shows that all questions of public income may be discussed under one of the three following heads:

1. Direct revenue, which leads to a consideration of public domains and public industries.

2. Derivative revenue, which leads to an analysis of the principles and a study of the practice of taxation.

3. Anticipatory revenue, which leads to an investigation into the principles of public credit.

(2) *Comparison of Direct and Derivative Revenue.*—It will be of great assistance in our effort to gain a comprehensive view of the general subject of public revenue if we inquire a little more closely respecting the character of direct and derivative revenue, and carry their comparison and analysis a step further. In this we shall confine ourselves in the first instance to a consideration of the regular and orderly sources of public income.

Public domains and public industry are alike in that the payment made into the treasury on account of them are made in return for a definite and specific privilege or service. Where government owns land and assigns it by lease for cultivation, public revenue is a rental paid by the tenant. Where government owns and administers the forests, the revenue which it secures arises from the sale of lumber or charcoal. Where government owns and manages a system of

railways the revenue accruing is collected through sale of transportation. A stamp placed upon a letter is the price for carrying the letter, and the government collects its postal revenue from the sale of stamps. The significant fact in all these cases, as in others that might be mentioned, is, that the citizen presents himself before the agent of the State as a purchaser of some privilege or service, and the amount he pays holds some definite relation to the quantity and quality of the service rendered. The relation between the citizen and the State is the "contractual" relation. The payment is freely made at the time of purchase and the citizen knows what he gets for his money. In this regard revenue by taxation is of an entirely different sort. It arises from payments made for a general and not for a specific service, and the service supported by the payment cannot be measured in any way to the citizen. The service is general in its character, and any attempt to measure it out to the citizen in proportion to payments would result in the destruction of the service itself.

Another distinction between direct and derivative revenue is that the former is voluntary while the latter is coercive. Much confusion has arisen in treatises upon finance on account of the different ways in which these words are used. By some a voluntary payment is understood to be a payment no greater in amount than could be demanded for a specific service were the price of the service determined by competition. This conception of the phrase necessitates a separation of the payment made for the service from which the State hopes to secure a general as well as a specific revenue into two parts—the one covering cost, the other reckoned as a profit. The former is said to constitute a voluntary payment, the latter a coercive payment, and on this account the profit to government on a commercial industry is said to be a tax. This distinction, although plausible when presented in this manner, is of slight advantage. No important administrative rule can be based upon it, nor is it sufficiently characteristic to be easily carried through a scientific treatise. Wherever a monopoly exists, whether public or private, an extraordinary profit is liable to make its appearance; but one would not on that account care to say that he who purchases from a monopoly is coerced to make the payment. It is of course true that if he desires the commodity he must meet the conditions of the only agency that

can supply him with it. He must pay the monopoly element as well as the cost element in the price in order to secure the goods, but one cannot say on this account that he is coerced in the one case more than in the other. Payment of the monopoly element in a price is merely the condition of his securing the commodity or service in question; but he may if he choose forego the purchase, and so be free from the payment of either. The point is this. Coercion which springs from one's desire to possess or enjoy a definite thing is wholly different, in its origin, in its character, and in the results which follow from it, from the coercion exercised by the government when it secures revenue from taxes. The one is the coercion of a specific desire, the other is the coercion of a sovereign power. The one finds its compelling force in the free choice of the individual, the other in the sovereign will of the State. A classification of revenue which fails to distinguish between commercial and political coercion can only lead to confusion. It is hoped in this treatise to avoid such confusion by refusing to acknowledge at the outset the alleged similarity between profits accruing from a government industry and taxes imposed upon private industry.

It appears from the above discussion that derivative and direct revenue differ from each other in that the one is built from payments for a specific service, and is made voluntarily by the citizen; the other is built from periodic payments, with only the general advantages of government in mind, and is a coerced payment in the legal sense of that word.*

A third distinction, though it is administrative and practical rather than general in character, is found in the fact that direct revenue is frequently assigned to special expenditures, while derivative revenue is commonly thrown into a general fund out of which all general appropriations for the public service are paid. The tendency is strong towards the practice of a consolidated fund.

(3) *Bequests and Indemnities*.—Besides revenue from public domain and public industry, there are two other sources of revenue which are direct in character. The State may in its

* In the discussion upon taxation it is shown that the justification of the coerced payment rests upon the moral sense of the community, which demands that a general service should bear with equal weight on all members of the community.

corporate capacity be the recipient of gratuities either from citizens or from other States. Such, for example, is the bequest of *Smithson* to the Federal Government for the establishment of the *Smithsonian Institution*. Such also is the bequest of land from the Federal Government to the States for the support of common-school and university education. Further illustrations of public revenue by gratuities are found in the frequent gifts made by individuals to municipalities in the form of parks, or for the purchase of fountains, statuary, pictures, and the like. Commonly, however, revenue from this source is appropriated to some specific service in the articles of bequest; and while it adds to the property of the State, and is of great significance for the development of the people, it does not in any way relieve the demands upon the people for the support of the ordinary functions of government. It is referred to in this connection that our analysis of public revenue may be complete. It is a revenue that accrues on account of the corporate character of the State by which it is enabled to become the trustee of funds designed for social benefit.

Another source of unusual or accidental revenue is found in the indemnities which a conquering nation is apt to demand from a vanquished people at the close of a war, in the judgment of international boards of arbitration, or in the agreements entered into by nations in case one nation for any reason claims damages from another. After the *Franco-Prussian War* Germany received five milliard francs from France as a war indemnity. Japan also secured an indemnity of one billion yen from China as one of the conditions of granting peace. It may be said, indeed, to have become an established practice that the conquering nation should receive indemnity for the cost of a war. From the financial and industrial point of view it is more than questionable whether the nation that receives the indemnity is thereby benefited. It is apt to induce habits of extravagance and to lead to the establishment of services which, when the indemnity fund is exhausted, will necessitate an increase in the rate of taxation; or, should this evil be avoided, a government will find great difficulty in expending so large a sum of money without disturbing the orderly course of trade. On the other hand, should the government which receives the indemnity en-

deavour to avoid this evil, it is likely that by withholding so considerable a sum from the ordinary circulation it will affect injuriously commercial conditions. In view of the possible difficulties which attend the receipt and expenditure of a national indemnity, it is not strange that the board of directors of the Bank of Japan should have presented to the council* of the bank this question. How may the Chinese indemnity be employed to the greatest advantage and the least disadvantage? There is perhaps in the entire range of financial problems no question more attractive because of the possibilities which it presents for broad generalization than this question of revenue by indemnity. It does not, however, bear that relative importance, when compared with other questions, which justifies further mention of it in this treatise.

(4) *Fees and Assessments*—Assuming that all revenue is either derivative or direct, where should fees and assessments be classed? Before undertaking to answer this question it would be well to make sure that the terms themselves are understood. A fee is a payment made to the State on the occasion of some specific service rendered by the State to the citizen, the service, however, being non-commercial in character. Two or three illustrations will make this clear. The payment demanded for recording a deed or mortgage, or for any legal process, is a fee, so also is the payment required to secure a passport or license (this latter, however, should not be confounded with a license tax), or for the issue of a teacher's certificate or diploma; so also is the payment for connecting with a public sewer, or for the privilege of purchasing light and water from a municipality. All these payments and many others for like services, or permits, are called fees. They are, however, in no sense the price paid for the service rendered or the permit granted. While it is true that they recognise a specialization in the service, they are in no sense a *quid pro quo*. The amount fixed bears no relation to the importance of the service, and only in a few cases to the quantity or the quality of the service. For the most part, services which are made the

* The Bank of Japan provides in its organization for a council composed of seven members to whom all questions of a general or public nature are referred. This council is made up of specialists in finance and political economy. The authoritative decision of course lies with the board of directors.

occasion of a fee do not permit of quantitative assessment; nor is the purpose of the government in demanding a fee that the aggregate of moneys thus secured shall equal the expenditure incident to the service

As further characterizing fees it may be said that the service rendered by the government for which a fee is charged is not commonly the comprehensive or fundamental service which the State has in mind in the adjustment of its governmental machinery. It is rather a service which arises incidentally in connection with some comprehensive governmental function. Thus the maintenance of foreign relations is a general governmental function, but the granting of a passport or the visé of an invoice is merely incidental in the administration of foreign affairs. The maintenance of justice in the business relations of citizens is one of the fundamental aims of political organization, the recording of a deed or of a mortgage, on the other hand, is required in order to render justice in commercial dealings easy and sure. In the same way the fee for a diploma is incidental to the administration of public education; so also the fee for a sewer connection is incidental to the administration of the health department of a municipality.

In view of the above considerations it appears that a fee is more properly classed under the head of derivative revenue than of direct revenue, that is to say, it is allied to a tax and not to a price. Although paid on the occasion of a special service, it is not paid because of that service, but rather because the government selects a certain occasion in the performance of its general functions for the levy of a special tax, and levies that tax to the individual with whom at the time it comes in contact

A special assessment is defined by Professor Seligman as "a compulsory contribution levied in proportion to special benefits designed to bear the cost of special improvements to property undertaken in the public interest"*. This definition implies, first, that the improvement which is made the occasion of payment is primarily for the benefit of the public, and secondarily for the benefit of the individual on whose property the improvement abuts. The paving of a street, for example, while it adds to the value of abutting property, is usually re-

* *Essays in Taxation*, p 283.

garded as a work pertaining to social rather than to private economy. In a very free sense, an assessment is in this particular allied to a fee. The service rendered by government to the individual who makes the payment is of secondary importance as compared with the general service involved. In practice, however, the assessment differs from a fee in that it is attempted to assign a payment to the individual in proportion to the benefit received. The definition implies in the second place that a special assessment constitutes a "compulsory contribution" which shows that, although the payment is a *quid pro quo*, it is not a price for service rendered. The transaction lies within the domain of social and not of free economy. Nor is the compulsory character of the assessment confined to the fact of payment. The decision as to the character of the improvement, as well as to the time at which it shall be undertaken, rests with the public authorities. In a double sense, therefore, an assessment may be regarded as a compulsory payment.

Our conclusion then is that assessments like fees are allied to taxes and are, on that account, to be classified as special forms of derivative revenue, at the same time they are in a greater or less degree adjusted to the idea of a special service, and for that reason should be granted an analysis separate from the general discussion of taxation. In this, however, we cannot go so far as do many German writers of prominence who recognise fees and assessments as a distinct source of public revenue.

The classification of public revenue which gives form to the present treatise is the following:

| | | | | |
|-----------------|---|-------------------------|---|---|
| Public Revenue. | { | 1. Direct Revenue. | { | a. Public Domains |
| | | | { | b. Public Industries. |
| | | | | c. Gratuities or Gifts, or Treasure Trove |
| | | | | d. Confiscations and Indemnities. |
| | { | 2. Derivative Revenue. | { | a. Taxes. |
| | | | { | b. Fees. |
| | | | | c. Assessments. |
| | | | | d. Fines and Penalties. |
| | { | 3. Anticipatory Revenue | { | a. Sale of Bonds or other Forms of Commercial Credit. |
| | | | { | b. Treasury Notes. |

(5) *Revenue from Expropriation* —It will be observed by one familiar with the literature upon this subject that the above classification of public revenue fails to include revenue from expropriation. Under this phrase is included the process of taking property through the exercise of the right of eminent domain. The reason for declining to recognise expropriation as a phase of revenue is that the State cannot, by any conceivable use it may legally make of the power of eminent domain, increase its income. The utmost it can do is to enforce an exchange of property. The government has a right under this sovereign power to take from a citizen whatever is accounted essential for a public purpose, but it is under obligation to return to him an equivalent for what it takes. In case an equivalent is not given in return, the act becomes either spoliation, which is an abuse of law, and therefore not to be considered among the sources of orderly revenue, or confiscation, which rests upon an entirely different power than the power of eminent domain. For these reasons property expropriated from private to public use is not counted as a public revenue.

(6) *The Lawyer's Classification* —It will be further observed that the classification here set forth pays no regard to the legal authority upon which the State rests its appeal for revenue, and in this respect differs from what (for want of a better name) may be termed the lawyer's classification. It is not intended to convey the impression that questions of constitutional right are of no importance in the adjustment of a fiscal system, they are of the utmost importance, as was clearly pointed out when the fiscal axioms were under consideration. Especially in the United States, where the courts have the last word on the constitutionality of a law or the legality of a method adopted for its enforcement, is it essential that the financier have clear and distinct views upon questions of legal authority. When, however, one observes the inextricable confusion into which the courts have drawn the nomenclature of finance by endeavouring to classify public revenue according to the governmental powers brought forward for their legal support, he is justified in expressing a doubt as to the advantage of the classification. The truth is that a given revenue may rest upon any one of several powers according to the purpose for which it is levied; or, indeed, it

may rest on several powers at the same time. Duties on imports, for example, may appeal to the taxing power, to the power to regulate commerce, or to the general welfare clause of the Constitution for legal justification, or it may appeal to all of these powers which the Constitution confers on Congress; but the duty is a duty in any case. The fees imposed on hack-drivers or newsboys may rest entirely on the police power, and a lawyer might urge that power to the exclusion of all others in the defence of the ordinance, but the fact that the fee is dependent on police regulation does not take it out of the category of taxes. It is right for lawyers to classify the sovereign power of the State, and to rest their arguments in support of the various forms of revenue upon one or all of those powers; but to define revenue in the language of legal pleading must inevitably lead to confusion. The nature of revenue is one thing, the nature of legal authority to set revenue machinery in motion is quite another. It is believed that the classification of revenue according to its nature will enable the student to obviate many difficulties that might otherwise arise.

38. Comparison of Public and Private Industry.—The foregoing analysis aims to disclose the general characteristics of public revenue. As further suggestive of the fundamental conceptions involved we shall now proceed to a cursory comparison of public and private industries, and to inquire if the general attitude of government toward the public is changed in any marked degree on account of the fact that it presents itself in connection with an industrial enterprise.

There are but two reasons why government should care to undertake an industrial enterprise—the one is that it may be of service to the citizen, the other that it may obtain a revenue for itself. The building and control of a railway is typical of the former, the French tobacco monopoly may be mentioned as an illustration of the latter. One must not think, however, that these two aims cannot be present in the same undertaking. Indeed, it is the rule rather than the exception that both objects are held in mind in connection with such industries as the government chooses to undertake, and, while it may be true that this renders the administration of the public business more difficult than would otherwise be the case, it must be allowed that the advantage to the public is on this account greatly increased. It is certainly wise to obtain revenue in

such a manner as to render incidental benefits whenever that is possible

Naturally the administrative rules which appeal to the financier will vary according to the purpose for which the industry is undertaken. If revenue be the chief object, the policy of control will tend to adjust itself to what is known as strict business methods. The principle of private financing will be put in practice so far as that may be done in view of the sovereign character of the State. This generalization brings to the front a very important question. In how far is it possible for the State to divest itself of its sovereign character when it invests itself with the rôle of an undertaker ?

Many writers assert that no essential difference exists in matters of business between the State and the individual, and they proceed in their discussion of public industries as though government were at liberty to adopt as its own the business policy of a corporation or of an individual, and to adjust its charges upon strictly business considerations. One may, however, doubt the pertinency of such a conclusion. In every sphere of its activity the government stands for the whole people. The State is obliged from the necessity of its own nature to regard the general effect, as well as the immediate result, of its acts, and on this account it is debarred from adjusting a business policy to the principles of private financing. It cannot, for example, resort to any of those devices by which trade is enticed from a private concern performing the same or analogous services. This is true because the competitor of the government is a part of the State, and the State is obliged to recognise that damage to such a competitor is damage to itself. The State is as much interested in the success of what its citizens undertake as in the success of its own business enterprises, and for this reason is obliged to assume the comprehensive or social point of view, and to consider the general and ultimate, as well as the particular and immediate, results of its business policy.

As further illustrative of the peculiar character of a public enterprise, it may be said that a public industry cannot recognise the wholesale principle in dealing with its customers, since it has no right to discriminate in price in favour of the large and against the small buyer. It is a fundamental principle of democratic government that all citizens should stand as equals

before it, and it would be as dangerous to disregard this principle in the administration of industry as in the dispensation of justice

If the distinction thus brought to notice be accepted (and it must be admitted that many writers on finance fail to recognise it), it follows that public utility rather than industrial profit must be the ruling consideration in all public industries. The State has no private interest and cannot follow, without modification, the rules of a private business. The phrase "private price" or "*quasi-private price*" finds no place in discussing an industry carried on by government. The private price is commonly the competitive price, and is always fixed with a view to the highest possible profit; the public price is a governmental price, and is adjusted to the idea of the highest social utility. It may be that, incidentally, the same charge will be made by government aiming to secure social utility as would be the case if the industry were administered upon a competitive basis; but the process of getting at the charge is so different in the two cases that one is justified in asserting that the charges themselves stand for essentially different concepts and represent essentially different social forces.

The practical outcome of the fact that the State cannot divest itself of its sovereign character, even though it undertake a business for the purpose of securing a profit, is that public industries will, as a rule, be organized as legal and exclusive monopolies. In no other way can that symmetry in organization and harmony in administration be maintained which are essential to a just regard of the social interests. There are of course exceptions to this rule. The government might, for example, own and administer a railway, not for the purpose of revenue or with a view of rendering a direct commercial service, but in order to establish and maintain the conditions of equity for the conduct of industries intrusted to individuals and corporations. To speak specifically, the State might choose to own a railway in order to coerce competing railways to charge a just price or to provide conditions of normal competition between merchants and manufacturers. Even in such cases, however, the industry owned by the government does not subject itself to the law of competition; on the contrary, it makes use of competition in order to con-

trol competition In all cases it is the governmental principle, rather than the commercial principle, to which the administration of a public industry looks for guidance

The difference between a public and a private industry would be yet more clearly disclosed by inquiring respecting the principles upon which the government must rely in adjusting the price for such commercial services as it renders, but as this question is made the subject of special discussion in a subsequent chapter it will not claim our attention in this connection ¹

39. Marks of a Good Revenue System—In order to prepare for deciding properly the technical questions which come up in the discussion of the various sources of public revenue, it may be well at this point to consider the marks of a good revenue system. The most important of these are as follows:

First A good revenue system must be adequate to the just wants of the State This is more than a truism Not only must the government be able to secure such moneys as it needs, but it must be able to do this easily and without apparent effort Difficulty in securing revenue acts as an obstacle to the performance of any duty which may be assigned to government, while, on the other hand, the impression that the State is in possession of adequate funds, or may easily secure an increase in revenue, brings to it such strength and dignity that tasks which would otherwise be difficult in their performance are accomplished with ease Especially is this true in the case of diplomatic negotiations The effect of an argument depends more upon the power of the nation which asserts it than upon the reasonableness of the argument itself, and in these days of expensive military and naval equipment national power is in large measure dependent upon money or the ability to command money In case government desires to enter upon a contract calling for large payments, also, a full treasury will enable it to secure lower bids than might otherwise be the case Or, suppose the currency system of the State to be in any way dependent upon the maintenance by the government of a bullion reserve, a deficit under such circumstances, or even the danger that a deficit may arise, might easily result in commercial embarrassment Other il-

* Cf. Part II, Book I, Ch. VI, § 45.

illustrations present themselves, but the above are adequate to show the importance of a revenue system which secures an ample income without apparent effort. The first mark of a good revenue system is that it succeeds in getting the money.

Second. The second mark of a good revenue organization is that the financial policy of a State presents itself as a system and not as an aggregation of independent and unrelated acts. It is a fundamental principle of government that the burden of the State should rest equitably upon all citizens, but it is impossible to secure such a distribution of the burden unless all of the many ways in which revenue machinery touches the citizen are classified, compared, and reduced to a system. The persistent effort on the part of legislation to avoid "double taxation" shows the necessity of regarding every law as a part of a comprehensive whole. The suggestion here presented will meet with universal approval, though in practice it is almost as universally disregarded. The financier is not at liberty, according to the theory of equity held by democratic peoples, to judge of a law for raising revenue without considering it in its relation to the entire revenue system.

A few applications of this principle will show its meaning more clearly. Should the State undertake an industry which is especially lucrative for the sake of securing revenue, thus presenting itself as a competitor to citizens engaged in the same industry, it should exercise great care lest in adjusting its system of taxation it impose a burden upon its competitor from which it itself is free. That is to say, the taxes which it levies upon private industries must be levied in view of its own industrial undertakings. Again, some taxes which could not be justified in and of themselves are capable of easy justification when considered as a part of a comprehensive revenue system. In 1789, for example, when the first tariff act was under discussion in Congress, the objection was urged against imposing a duty on salt that this would bear grievously upon the mountaineers of North Carolina and Virginia. The reply to this objection was that, according to the scheme of taxation under discussion, this was the only tax which would reach the citizens in question. Again, many duties are imposed as compensatory duties; that is to say, duties which would be unnecessary considered by themselves, but which

become necessary in order to provide the conditions under which revenue from other sources may be protected. The Federal Government, for example, imposes a duty upon the manufacturer of spirits within the United States; it must, in order to enable this industry to bear the tax and at the same time maintain itself against foreign competition, impose a corresponding duty upon the importation of spirits. The revenue system of every country is replete with illustrations of complementary and compensatory laws, and of laws designed to avoid double taxation, all of which goes to show that a sound fiscal system will be well balanced and comprehensive.

Third The third mark of a good revenue system is one which appeals more directly to a country organized as a federation, like the United States, than to a country more highly centralized for the purpose of administration, like France. Not only should the fiscal policy of a particular grade of government present itself as a comprehensive whole, but the several corporate bodies which together make up "the State" should exercise great care lest the revenue domain of the one encroach upon the revenue domain of the other, and by so doing bring confusion and inequalities into what otherwise might be a sound financial organization. To speak specifically, the third mark of a good revenue system is harmony and balance between the central and local governments, between the local governments themselves, and between the several organs of local government.

This point may be the best presented by considering the situation as it exists in the United States. There are in this country four grades of government, each of which has assigned to it a certain definite set of public functions. These governments are the Federal Government, the State governments, the chartered municipalities, and the local governments resting on general statutes. There is at present no separation of the sources of revenue corresponding to this separation of public duties. It is true that by the Federal Constitution customs revenues are set aside for the Federal Government, and, with the exception of the State of Texas, the public domain is the property of the United States; for the rest, however, there exists the greatest confusion. The evils which follow from this unsystematic method of procedure present themselves at every point in the discussion of

revenue problems Whether or not definite sources of revenue should be set aside for the exclusive use of the varying grades of government is a question which calls for more extended discussion than can be bestowed upon it in this connection It is, however, clear that some form of harmonious action between the several governments concerned is essential to the best results in a comprehensive revenue system. This is a mark of a revenue policy which it is especially important for the people of the United States to recognise

Fourth The fourth mark of a good revenue system is that it must provide for elasticity in the revenue at the point where elasticity is needed It is not sufficient, in order that a revenue system may be elastic, that public income shall be capable of easy increase in a time of emergency; it is equally important that income may be easily reduced when the emergency shall have passed away Elasticity as a quality of a revenue system does not appeal with equal force to all grades of government It is relatively of most significance for those governments that are exposed to emergencies and exigencies in the performance of their assigned functions To speak explicitly, this means that those governments that are clothed with the power of declaring war and concluding peace are the ones for whom elasticity in revenue is of the most importance. In the United States, for example, the revenue system of the Federal Government should regard this characteristic as of very great importance A municipal government or a county government, on the other hand, may practically ignore elasticity of revenue in the organization of revenue machinery.

Many other qualities there are of a good revenue system, but these will come up incidentally in connection with the discussion of the special questions as they present themselves. Those qualities of which mention has been made are the ones that pertain to the revenue system regarded as a comprehensive whole.

BOOK I.

DIRECT REVENUE.

CHAPTER I.

REVENUE FROM PUBLIC DOMAIN.

MINERAL DEPOSITS AND THE FISCAL POLICY

SURFACE LANDS AND THE FISCAL POLICY

- (1) Shall Government Cultivate its Own Domain?
- (2) Shall Government Lease its Domain for Cultivation?
- (3) Shall Government Dispose of its Domain by Sale?

LAND POLICY OF THE UNITED STATES

- (1) The Original Idea Respecting Land.
- (2) Use of Land for National Development
- (3) Use of Land for Educational and Railway Grants

UNDER revenue from public domain will be considered those forms of income accruing to the State on account of ownership of or interest in landed property. This phrase "landed property," however, must be interpreted very broadly. All of the so-called "extractive industries" present themselves for consideration in connection with the study of revenue from public domain, and under the extractive industries are included fishing, mining, and agriculture.

It is not necessary to consider at length the policy of the feudal system or of early States respecting fish. In England such fish as whale and sturgeon, called "royal fish," were the property of the crown wherever taken, but it is not known that they ever formed a considerable portion of the public revenue. At present it is the general policy of nations to consign this industry in all of its branches to private enterprise. Indeed, during recent years the most civilized peoples have expended considerable sums of money in the development of piscatorial culture, not with a view of making the industry itself a source of revenue, but for the purpose of opening up a new source of food-supply. In some cases, as, for example, the oyster-beds of Chesapeake Bay, the State secures

a revenue from the rental of the beds, agreeing on its part to protect the beds from depredations. But this is quite exceptional. Wherever fishing preserves are maintained, whether for industry or for pleasure, they are, as a rule, the property of private persons or corporations, and as such are listed as taxable property.

40. Mineral Deposits and the Fiscal Policy.—The revenue policy respecting mineral lands cannot be so easily stated. Not only is there considerable divergence in practice among nations in regard to mines, but there continues to be considerable difference of opinion respecting the appropriate policy. Gold and silver among minerals, like the whale and sturgeon among fish, were formerly declared to be royal property, and wherever found were appropriated by the State. In this form, however, the claim of the State upon minerals has long since been abandoned.

The general argument favouring the public ownership of mines is that minerals are the free gift of nature, and should, therefore, not be made the property of any individual. Even in countries where the surface lands are assigned to individuals for private cultivation, it has been proposed to reserve the mineral deposits for the State. This suggestion is found in the land policy proposed by Turgot, the great Physiocrat statesman of France. The policy which has come to prevail in the United States, however, and indeed in most countries, is to give title, in case of sale, from the surface to the centre of the earth. The argument which has led to the assignment of mineral lands as private property does not disregard the fact that minerals are a gratuitous gift of nature, but asserts, as breaking the force of this consideration, that nature has been so bounteous in her gifts that no injury can arise to consumers as the result of such assignment. Consider, for example, the wide extent of the coal-fields in the United States, as also the great number of iron-mines and salt-wells that abound. There is nothing in the nature of the case why competition should not determine the price of these products, and, in the absence of artificial restraints, the public finds, in the many opportunities for mining, a guarantee that mineral products of this class can be had at cost. There is, therefore, no more necessity from the ethical or commercial point of view for the government to own and administer such

mineral property than for it to take into its possession any other industrial enterprise. This being the case, the question as to whether or not mines shall be made the source of special income to the government comes to be a general and not a particular question.

But this line of reasoning does not apply to minerals which are localized to such an extent that they may be accounted a natural monopoly, as for example the zinc mines in the United States, nor does it apply to a mine which like the Calumet and Hecla of Northern Michigan was for a time so far superior to other copper-bearing mines as to enable it for many years to control the output and the price. A detailed study of the mining conditions of any country shows many exceptions to the assumptions of the argument for private ownership presented above.

It may be doubted, however, if the mining policy of any country has been directed by economic or ethical theories. The simple fact is that men will not enter upon the uncertain calling of a prospector unless induced thereto by the hope of great gain. This work cannot be undertaken by the government on account of its speculative character, and unless the hope of unusual returns is offered to men who by nature take a pleasure in speculation the deposits of unusual minerals will forever remain undiscovered.

It thus appears that all the considerations involved in the case of mineral lands do not range themselves on the same side of the question. On the one hand it is essential, at least in a new country, to grant free play to the speculative interests of individuals in order to secure the discovery of unusual minerals or of minerals of localized deposit. On the other hand it must not be overlooked that it is an injustice to the community as well as a source of a great social danger to assign rich mineral deposits to individuals or to corporations. Mineral wealth is the gratuitous gift of nature, and it would be a mistake for any government to ignore this fact.

There are two ways of harmonizing these conflicting considerations. In the first place, the principle underlying the patent laws may be applied to legislation respecting mines. This would give to those who discover mining property a limited rather than a perpetual lease, and in this manner the mines would ultimately become a source of income to the State.

The difficulty in applying such a principle is chiefly administrative, for it is probable that a mine held under a limited lease would be worked in an uneconomical manner, so that upon the expiration of the lease the property would be comparatively worthless.

The second way of meeting the difficulty is through the machinery of taxation. There is much to be said in favour of the policy of assigning mineral lands to private ownership, a policy which has finally been accepted by the United States, provided it be supplemented by some form of special taxation upon mineral property. It would be out of place, however, to consider at this time the form of the tax appropriate to the situation. The general conclusion of the foregoing discussion respecting the relation of a financial policy to mineral property is as follows: Mines that are widely spread and easily discovered may be treated like the property of ordinary industries. No special financial policy is required for minerals like coal, iron, or salt. Mines, on the other hand, which form the basis of a natural monopoly should be handed over to private enterprise for development, but they should at the same time be recognised as a fit object for special and peculiar taxation.

41. Surface Lands and the Fiscal Policy—Private property in land among peoples whose law of real property has been influenced by the feudal organization is universally regarded as a grant or privilege from the State. In the United States, for example, a clear title commonly bears upon its face a record of the transfer back to the original grant. Even where occupancy preceded survey and sale, as in the case of mining claims staked out by gold-hunters, it was thought necessary to legalize the customs of the miners and thus secure the occupiers in their property by a title from the State. Such being the theory of proprietorship, a comprehensive analysis of the relation of surface or agricultural lands to the fiscal system may, without violence to the working hypothesis of the law of real property, start with the assumption that all lands belong to the State, and that the conditions of their use are determined entirely by expediency, or by what is regarded, all things considered, as sound policy.

Surface or agricultural lands may be made to serve as a

source of income to the State in either of the three following ways

First, the government may cultivate the lands as a public industry

Second, the government may establish a tenantry upon its lands and receive an income in the form of rent

Third, the government may dispose of its lands and secure a revenue through taxation

Each of the above suggestions will be considered by itself. The immediate purpose of our consideration will of course be to determine the most practicable policy for modern states, at the same time, the necessity of discovering some general principles for determining those industries naturally adapted to serve as the source of direct revenue will be held constantly in view

(1) *Shall Government Cultivate its Own Domain?*—The dependence of the Science of Finance upon the principles of Political Economy will receive especial emphasis in connection with questions of taxation, but economic analysis is hardly less pertinent in connection with the above question. As is well known, farming is an intensive and not an extensive industry. It depends for success upon the personal care of the farmer and attention to minute details. The principle of division of labour is applicable to agriculture only in a very limited degree, and, on this account, the normal tendency of agriculture as a business is toward continually smaller holdings. The product of any particular farm continually must vary from year to year in order to adjust itself to the varying demands of the market, and it requires the greatest attention and care in a progressive agricultural community to adjust the output to the needs of the community. Without indulging further in comments of this sort, it will be readily seen that the business of farming is not capable of an organization adapted to governmental control. It cannot be subjected to general rules, nor can the workers be organized in an enduring and efficient industrial association. It would be necessary for government, should it undertake public farming, to make use of overseers and drivers, as was the custom in the days of slavery; and for the same reason that a high state of agricultural development was never reached on the basis of slave

labour, one is justified in asserting that agriculture under the direction of officers of the State would become an inadequate if not a stagnant industry. If this be true, it follows that the system of public agriculture would be detrimental to the highest industrial development, and this, even from the point of view of public income, to say nothing of the social interests involved, must be accepted as final against the suggestion that the government should secure a direct revenue from agricultural lands.

It is possible the analysis of the foregoing paragraph was not necessary to support the conclusion resting upon it. It is the general practice of modern peoples to refrain from undertaking directly the industry of farming. They have almost universally assigned such lands as they possessed to tenant farmers or sold them in fee simple to the occupiers. Austria began selling her lands in 1818; Spain since 1811 has disposed of nearly two hundred millions of acres of land. The budget of Prussia every year contains an item of income from the sale of public lands. The land policy of France introduced at the time of the French Revolution is familiar to all students. Some of the smaller kingdoms and principalities in Europe still retain their public domains, but, so far as the writer is aware, no important State at present maintains the policy of purchasing lands. Beaulieu in discussing this question presents certain facts designed to measure the relative efficiency of agriculture on the part of the State, and of the system of rentals under long leases by means of which the personal interest of the cultivator is brought to the task of cultivation. Three large domains were divided between one hundred and seven families, the average number of years covered by the leases being forty. The following is a statement of the results under the two systems of agriculture: *

| | Before the Division | After the Division. |
|-------------------------------------|------------------------|------------------------|
| Number of persons upon the domain | 45 | 595 |
| Number of horses | 10 | 124 |
| Number of cows | 16 | 333 |
| Production of wheat | 521 (wisp) | 1,414 (wisp.) |
| Consumption of wheat upon the place | 28 | 439 |
| Excess wheat for sale. | 410 | 752 |
| Product of cattle, eggs, straw . . | 7,765 (thalers) | 8,226 (thalers) |
| Total proceeds of products sold . . | 15,537 | 22,726 |
| Revenue to the State | 4,077 | 5,175 |

* Leroy-Beaulieu, *Science de Finance*, Vol. I, p. 41. It is copied by him from the fourth edition of Rau's *Finanzwissenschaft*, Vol. I, p. 172.

In the presence of such a comparison as the above, assuming the figures to be in any degree typical, the policy of government agriculture cannot be defended. The application of personal interest to land culture not only increases the number of individuals which the land supports, but increases the surplus of product for sale from the land, and the revenue to the State as well.

The foregoing analysis, as also the conclusion which is drawn from it, applies to the industry of ordinary farming. It furnishes no argument, however, against the retention by the State of land for the purpose of maintaining a system of public forestry. This is true because a system of forestry holds in view the rendering of a general social service, and should not be judged by technical results. Care of forests has always been an object of governmental solicitude. In former times it was considered of the utmost importance that a nation should have in its possession the material with which to construct vessels, and the possession of forests was under these circumstances an element of national strength. At present the form of argument is somewhat changed, but it is equally strong. Forests are now generally regarded as exercising a salutary influence upon the rainfall, upon the general health of the community, and as a means of mitigating in some degree the evils arising from floods and droughts. It is, therefore, a matter of general interest that a proper portion of the surface of any country should be covered with forests. The only question pertains to the best means of securing this result.

Both experience and analysis show that private enterprise is not capable of developing an adequate system of forestry. The time intervening between planting and harvest—at least thirty years—is too long to attract private investment. It is true that there is an increase in the value of land thus planted from year to year, so that in a sense the investor has an annual income from his investment; but the difficulty is he cannot realize upon this investment except he sell the land with the crop. For this reason, if for no other, forest culture must be undertaken by a corporation which not only represents the general social interest, but which enjoys a perpetual lease of life. The State is the only corporation which meets these requirements.

Although forestry may be undertaken for the general service which the government may thereby render to a community, it may become, under proper management, a source of net income to the State through the sale of wood and timber, charcoal and ash products. The experience of European nations with this industry shows that it may become the source of very considerable income. In France, for example, the gross income varies from thirty-eight to forty million francs a year, while the cost of administration is from twenty-five to thirty million francs. Taking the higher figures in each case, the percentage of expenses to gross income, in this country, is 75 per cent. The corresponding percentage in Hanover is from 80 to 85 per cent, in Bavaria about 50 per cent; in Prussia and Wurtemberg 48 per cent; and in Saxony 37 per cent. Should one include in his estimate the value of land assigned to forest culture, the showing might not be such as to justify the investment. In France, for example, the net income estimated on the value of the property shows a return upon the investment of less than 2 per cent. In whatever way, then, the matter be regarded, the conclusion remains the same. The development of a system of forestry must be classed as one of the general governmental services, and must be advocated on the ground of its social importance. The reason why the financier is obliged to consider this industry is that incidentally it gives rise to certain commercial products the proceeds of the sale of which may support the expenses of the service. The propriety of public forestry is further shown when it is recognised that, as an industry, it may be subjected to simple rules of a general nature, and its administration may be carried on with more or less regard to the principles of military organization. In this respect it stands in marked contrast with the industry of farming.

The principal difficulty in connection with the administration of a public system of forestry arises on account of the fact that the products of this industry may come into competition with similar products of private enterprises. Not all the timber can be grown upon government lands. Not all the charcoal and ash products can be furnished by the public forestry departments. These products of forest culture might also come into competition with artificial commodities

that serve the same general purpose, as, for example, lumber manufactured from straw, iron, aluminum, and the like, used for building purposes, other fuels may be substituted for charcoal, or chemicals may serve the purpose of ash products. A government cannot escape a competition with its subjects, and in the presence of such competition no government would be at liberty to administer its forestry system with a view to the highest possible net income. It is obliged to recognise the social and industrial tendencies bound up in its policy of administration, and to adjust the price of its commodities accordingly. In general it may be said that the price of the products of public forestry should be adjusted to the market price of goods with which they come into competition, the only exception to this generalization being defensible when the government finds itself in competition with a private industry which aims to maintain an industrial monopoly, and to charge a monopoly price for its products.

The policy of European states respecting forestry shows a marked degree of uniformity. At the beginning of the present century there seems to have been a tendency on the part of governments to alienate this kind of property, a tendency which perhaps may have been one of the mistaken applications of the prevalent theories respecting individual rights. From 1791 to 1795 France disposed of nearly one-half of her state forests and continued to reduce the forest area until in 1870 there remained but one-fifth of the original state holdings. Many of the German principalities also followed the same policy, selling off their forest lands which had for centuries been preserved as government property. They did not, however, go so far in this direction as France.

During the past forty or fifty years the old policy respecting state forestry has been revived, and nearly all European nations evince not only a desire to hold on to such forest property as they have, but to extend its area and efficiency, and to exercise a stricter control over the use of private forest property wherever communal interests are thereby endangered. In France since 1870 no sales have been made, but each year shows a gradual increase in the amount of land consigned to public forestry. Since 1872 the government has spent nearly 200,000,000 francs in the reforestation of dunes and devastated mountain-sides. In Prussia the policy

of selling forest lands prevailed in the beginning of this century, but since 1831 the opposing policy has made itself apparent. Between the years 1867 and 1895 over 22,000,000 marks were spent in increasing the forest area, and the budget for 1895 contains an item of 2,000,000 marks for the purpose of purchasing additional lands for this purpose. The increased efficiency of forests as a source of income is shown by the fact that in 1830 the cost of administration was 61 per cent of the gross receipts, in 1870 it was 52 per cent, in 1893 it was 47 per cent. In other German states the same tendency may be noted. Bavaria shows a 4-per-cent increase in forest area, Wurtemberg a 3-per-cent increase, since 1873. A small increase also may be noted for Baden and Saxony. In Austria the selling of forests continued until about 1870, but at the present time the State is the only great purchaser of forest lands. In 1886 60,000 acres, in 1888 230,000 acres, and in 1891 211,000 acres were purchased for this purpose. Both Italy and Russia, while too poor to spend much money in this manner, have nevertheless made a start in this direction. Russia sells timber lands to the communes but not to private individuals, and has enacted a strict law under which the general forestry of the country is to be administered. The English Government has no considerable amount of forests, but this is not due to the fact that the English are averse to governmental management of forestry culture. In India, where there is a decided need of forests, the government shows great activity. Between 1882 and 1892 the reserved forests were increased from 46,213 square miles to 59,743 square miles, while the total forest area under the control of the government increased from 71,972 square miles to 114,966 square miles.

No country has greater need than the United States of a comprehensive system of forestry, and no country, except it be the South American republics, has shown greater disregard of this need. The land system of the Federal Government makes no distinction between forest lands and agricultural lands. The same laws have been followed in the survey and sale of both classes of property, and in the main the same price has been demanded. This policy has resulted in the sale of forest lands as timber property to individuals and corporations, whose only purpose was to realize the largest

amount of money possible from their purchase in the least possible time—a policy which has resulted in the destruction of most of the timber lands east of the Mississippi and north of the Ohio. In the West and the Northwest very little care has been taken to conserve the public forests. Lavish grants have been made to railway corporations for the use of such timber as they needed for the construction of their lines, and no adequate provision has been made against the destruction of forests by fire. The only encouragement to tree-culture which Congress has seen fit to make has been in connection with its general land policy. Land has been given to settlers on condition of their planting and caring for a certain number of trees, but this has amounted to nothing so far as the development of a system of forestry is concerned.

Admitting the importance of a comprehensive system of forestry, the question naturally arises whether this should be done under the direction of the Federal Government or the State governments. Without discussing this question, the opinion may be ventured that the proper seat of authority for the administration of the forestry system is the State governments. This would obviate quite a number of difficult constitutional questions which might embarrass the administration of the Federal Government owning forests within the jurisdiction of the States. From the financial point of view, also, there is much to be said in favour of such an investment by the State governments. The chief difficulty in connection with this question of forestry has been that it has never been regarded from a comprehensive point of view, and this can never be done until it is made a part of the fiscal system of the Federal Government or of the State governments. Each year that passes renders the solution of the problem more difficult. The Federal Government should at once undertake to conserve the forests which remain in its possession, and the State governments should enter upon a policy of acquiring land for the purpose of extensive tree-culture*.

Closely connected with the question of forestry, and allied to it so far as social considerations are concerned, is the problem of irrigation. Many countries have no problem of

* At all events a tax ought not to be imposed on the import of lumber from other countries, thus encouraging the destruction of such forests as we have.

this sort, the ordinary rainfall being adequate for agricultural purposes. In other countries irrigation has existed for so long a series of years that riparian rights constitute a permanent element in the valuation of landed property. The question, therefore, will be discussed in view of the conditions as they exist in the United States. It is estimated that there are seventy-four millions of acres of land that might be reclaimed for cultivation by means of an adequate system of irrigation*. Already certain corporations, notably the insurance companies, have invested capital with a view to meeting this demand. In so doing, however, they seize upon the most generous sources of supply. The canals thus constructed do not form a part of a general comprehensive system of irrigation, nor are they administered with a view to the highest industrial development. Already many difficulties have arisen between users of water and the corporations which own the water-supply. Laws have been passed regulating the price of water, and the courts have sustained these laws on the ground that irrigation companies are common carriers. A set of cases, for the most part unknown to the American courts, have arisen in connection with the private ownership of water-supply, and one who is familiar with the development of the law of riparian rights must recognise the difficulty of the problem which concerns this country in case the western territory is developed through private ownership of irrigating canals. In view, therefore, of the fact that a very considerable portion of the territory which needs irrigation will be left destitute of a water-supply if the business of rendering this supply is intrusted to corporations, and in view of the further fact that wherever private supply through corporations has been tried very serious difficulties have arisen as to the rights of consumers to the use of the water, it must be admitted that a strong argument is presented in favour of public ownership of ditches and canals. If such ownership be decided upon, it follows, in view of the conditions under which the industry is carried on, that the irrigation system will be made a part of the fiscal system of the State.

(2) *Shall Government Lease its Domain for Cultivation?*
—Any discussion which involves the relative merits of sys-

* This is the latest estimate of Mr. Newell, hydrographer of the United States Geological Survey.

tems of land tenure must proceed along broader lines than lie strictly within the consideration of the financier. Among the marks of a good revenue system is its adaptation to the permanent trend of opinion upon social and industrial questions. If the public be convinced that a system of tenant-farming, in any of its various forms, is better than farmer proprietorship, it is quite easy for the public treasury to adjust itself to such a conviction, and to demand its income in the form of a land rental rather than in the form of a land tax. But the trend of public opinion for centuries has been in the opposite direction. The commutation of the rentals of feudal times into modern taxes is generally conceded to have been an important step in the advance of Western civilization, it being intimately connected with the rise of private property in land and the development of a higher technic in agriculture.

This being the case, it may at first appear unnecessary to consider revenue from land rentals as among the possible forms of public income, or to concede to this idea the courtesy of a discussion. Against such a conclusion, however, several considerations present themselves. In the first place, there are quite a number of governments which still hold to a system of public tenantry. In the second place, among the socialistic and semi-socialistic theories that to-day agitate the public mind, will be found the claim that land cannot justly be alienated by the State. It is, in the third place, conceivable that the structural changes wrought by four centuries of private ownership in land have brought with them the necessity for more direct and positive governmental influence in matters pertaining to agriculture than can be accomplished through the medium of taxation. And lastly, much is to be learned of the relation of land to the public treasury by a discussion of the state lease system. For these reasons the policy of land rentals will be given a cursory examination.

At first glance, it seems that no two things could differ more widely than a society in which land is owned by the State and leased by the occupier, and a society in which the occupier is, or may become, the proprietor of the soil which he works, but a slight consideration shows that this difference is not so much in the nature of the two forms of holding as in the terms of the tenant's contract. Every one

knows that the price of land is its rental value capitalized at an assumed rate of interest, due allowance being made for social and speculative interests. It is a strong statement of the case, although within limits a correct one, that the occupier who owns the land is its tenant in perpetuity, while the occupier who rents the land is its owner until the expiration of the lease.

Working into the question from this point of view, it appears that progress in the art of agriculture under a system of tenantry, so far as that depends upon the care and thrift of the occupier, will approximate the results that are observed to follow when the farmer is also proprietor, in proportion to the length of the lease and the liberality of the contract. It is, therefore, conceivable (the probabilities of the case are not here brought into question) that as good technical results may be shown under a system of tenantry with long lease as under a system of free holding. It further appears from this comparison that the rent paid by a tenant to the State approximates a tax in proportion to the length of the lease. Under a system of annual lease the payment for land will be determined by competition and will equal the full economic rent. That is to say, the government will take the total of the "excess profit" arising from the industry of farming, leaving to the farmer his wages as a labourer, and the interest on improvements, provided they represent an investment of his capital. The government might, it is true, leave a portion of this pure rent in the hands of the tenant and in this manner create a system of rent-sharing between itself and the tenant. According to modern fiscal theories by which the revenue of the State is determined according to public necessities, this must be the case, since the payment by the farmer of the full economic rent to the State would result in his paying a relatively higher amount than would be paid by those engaged in commerce or manufacture. The form which this concession to equality would probably assume would be the substitution of a time lease for an annual rental. It thus becomes apparent that, in case fiscal rather than commercial principles determine the amount of payment, no essential difference exists between a land tax and a land rent, and the substitution of a system of tenantry for a system of freeholders, provided the tenant's lease is recognised as nego-

tiable property, would involve no very radical change as compared with the present system of farmer proprietorship

What, then, it may be asked, are the considerations urged by those who favour a rental of public lands? These considerations are not very coherent, nor do all of them pertain directly to the Science of Finance, but it may be well to pass them in rapid review

In the first place, quite a number of detached suggestions present themselves which rest upon the assumption that better general and technical results would follow should the industry of agriculture be placed under the direction of government than if left to develop at the hands of a large number of independent owners. It is urged, for example, that under a tenant system the contract for occupancy might be so drawn as to check undue morselization of land. A further illustration is found in the suggestion that the State as a landholder would be in a position to introduce scientific methods of farming, and to so direct the cropping of land that the supply of agricultural products would meet a statistically determined demand

These are both interesting suggestions and typical of others of the same sort that might be made. They bring into contrast the relative merits of two theories of social progress, the one of which calls upon the State to exercise direction in industrial affairs, while the other finds in the survival of the most successful among many experiments the surest path to technical progress. One who entertains the latter view cannot doubt respecting the superiority of the system of agriculture as it exists in the main in the United States. Under no other condition except that of ownership of the soil by him who works it can the spirit of venture and invention be brought to bear upon the industry of agriculture. As has been already suggested, this business embraces too many details to flourish under the influence of administrative advice. There is, for example, no determinable size for a profitable farm. This varies with the crops to be cultivated and the means of cultivation. It would be much wiser to remove the social or political influences which lead to excessive subdivisions of land, than to enter upon an official analysis of details for determining the normal size of a holding.

So far as the second of the above suggestions is concerned,

mately become public property, and, until there is a general sentiment in the community favouring this way of thinking, it is unnecessary for the practical financier to consider the suggestion

The third suggestion in favour of leasing rather than selling the public domain presents itself as part of a general financial system. All governments must prepare for financial exigencies, and it is claimed that a retention of a considerable portion of the public domain would secure the means of making headway against an unusual demand for money in time of exigency. This might be done in either of two ways: the lands might be sold, or they might be used as security in the borrowing of money. The question thus raised as to the best means of providing against a fiscal exigency is one which will receive consideration in the discussion of Public Credit. If it be necessary, in order to provide against fiscal emergencies, that the State should retain proprietorship over a considerable portion of agricultural lands, the argument in favour of the tenant system of agriculture is a strong one, but a moment's consideration will make it clear that the proposal is wholly inadequate to the end in view. In the first place, it is altogether unlikely that the land could be sold under conditions of fiscal emergency such as are assumed. Suppose, for example, that there arises an unusual demand for public revenue on account of war. Is it not certain that the disturbance of industrial conditions incident to war will preclude the possibility of sale except to those who might invest for the purpose of speculation? This means that the lands will be disposed of at low prices, and that the purchasers will be, in all probability, the most undesirable of all purchasers. In this connection, too, it should be remembered that, in order to make of this suggestion a permanent policy, the government would be obliged to repurchase lands when the exigency shall have passed. This policy, therefore, forces a sale when prices must necessarily be low and forces purchase when prices will probably be high.

It may, however, be urged that money to meet a fiscal exigency may be raised by a mortgage upon the land. This, it is true, avoids the criticism involved in the proposal of sale, but it overlooks the fact that a public bond issued by a sovereign State is worth no more in the

form of a mortgage than as a mere promise to pay. No tribunal can force the foreclosure of such a bond in case of default. This being the case, the price of a government bond will be higher if it rests on the general property of all industries than if based upon a particular property incident to a particular industry. A government which enjoys public credit so as to enable it to borrow money at all will find itself at a disadvantage if it encumber its loan policy with land mortgages. It therefore follows, whether one considers the sale of agricultural lands held under lease, or their mortgage as security for money borrowed, that the argument in favour of the retention by government of cultivated lands is inconclusive. The retention of land as a fund of value to be used in case of fiscal emergency does in a very incompetent manner what may be more easily and cheaply accomplished by the direct use of public credit.

One word further may be added respecting the general policy of leasing public lands. It is an exceedingly dangerous policy. A government which is sufficiently strong to administer wisely the details arising in connection with a system of land tenure will be tempted to exercise that power in a tyrannous manner. On the other hand, a popular or democratic government, which is the only one that could with safety to the liberty of its citizens be intrusted with the exercise of a landlord's rights, is not strong enough to administer those rights efficiently and in harmony with a systematic plan. There is something incongruous in the idea of establishing the relation of landlord and tenant between a government and its citizens where the citizens are the government. A complete analysis of the question would disclose the fact that private property in land is one of the essential conditions for the satisfactory working of popular government. This is final against the lease system, except the leases be drawn for so long a period, and in such liberal terms, as practically to amount to ownership in fee simple.

Reference should be made in this connection to what is popularly known as the "single tax" theory, which from one point of view may be classed as a proposition to replace the system of free holdings by the tenant system. This plan proposes to substitute for all forms of public income an annual payment equal to the full rental value of the land. The title

in the land will not on this account be disturbed, although all income arising from the land in excess of labourers' wages and interest on improvements, that is to say, the proprietor's income, will be transferred to the State. Under such conditions no motive to own land exists, except such as arises in connection with occupancy, and the justification for classing this project as a proposition to create a tenant system with the State as a landlord is found in the fact that the amount which the land pays to the government would be determined by the competition for occupancy and not according to an estimate of public needs.

If the "single tax" theory be a project for creating State tenants in disguise, it should be judged on the basis of the broad question of public *versus* private ownership of land. Its acceptance would be the reversal of eight centuries of the history of the English-speaking people. This is as far as it is necessary to consider the "single tax" theory in this connection*.

(3) *Shall Government Dispose of its Domain by Sale?*—It is not necessary to discuss this question at length. The considerations urged against direct farming by the State and against a system of tenantry are considerations in favour of a system of ownership by the occupiers of land. The conclusion that the State should dispose of its domain to citizens, with the exceptions cited above of forestry, irrigation, and other like public services, carries with it the idea that landed property should be made a source of derivative rather than of direct revenue; that is to say, it should be recognised in formulating a scheme of taxation. The further discussion, therefore, of the position occupied by agricultural lands in the general fiscal system will be postponed until we come to consider the general principles of taxation. Our conclusion at this point is that the revenue from real property should be in the form of a tax and not in the form of a price or a rent.

* The chief argument urged by the single-taxer has nothing to do with finance. It is supposed to be the means of annihilating poverty. Its advocates form themselves into "anti-poverty societies." It assumes that the unearned increment pertains exclusively to landed property, and that the single tax on land would create "free land." This part of the argument is considered in connection with the discussion of land taxes. § 66, (2).

✓ 42. **Land Policy of the United States.**—It may be interesting in this connection to sketch briefly the land policy of the United States. At the close of the Revolutionary War a serious embarrassment to the establishment of a central government was found in the conflicting claims of the newly created States to the lands ceded by the Treaty of Ghent. The original grants to the colonies were made at a time when little was known of the extent of the North American continent, and it is not strange, in view of the loose language of those grants, that the same tracts should have been claimed by two or more States*. Moreover, some of the colonies held title to large tracts of land, while the holdings of others were small and explicitly defined. Maryland, for example, had no claim upon lands west of the Alleghenies. After considerable discussion it became evident that no just settlement of boundaries was possible, and, inasmuch as all had contributed in blood and treasure to securing the cession from Great Britain, the opinion finally prevailed that, in order to perpetuate the Union, it was essential that each colony should grant to the central government such rights as it might hold in Western lands. Omitting mention of minor exceptions, this was ultimately accomplished, and in this manner the Federal Government came into possession of an immense domain.

To the lands thus ceded by England were added the Louisiana Purchase in 1803, the Spanish cession in 1819, the annexation of Texas in 1845,† the first Mexican Purchase in 1848, the Gadsden Purchase in 1853, and the Russian cession in 1867‡. This gave to the United States an area of 2,970,000 § square miles of territory. The title of the Federal Government has never been questioned, and the title of the individual or the corporation holding from the Federal Government is superior to attack.

(1) *The Original Idea Respecting Land*—The first idea held by American statesmen respecting the public lands was that they should be made the basis of public financiering. Being

* Cf. *Maryland's Influence upon Land Cessions to the United States*, by Dr. H. B. Adams, Johns Hopkins University Studies in Historical and Political Science, 3d Series, No. 1.

† Texas did not cede her lands to the Federal Government.

‡ For map showing cessions cf. Johnston's *History of the United States*, p. 166.

§ Exclusive of Alaska, which has 531,000 square miles.

a joint inheritance to all the people, it seemed proper that they should be used as a fund of wealth for the advantage of the people. It was expected that taxes would be less by virtue of this property. Ample evidence supporting this statement may be found in the expressions of the time, and in the writings, the speeches, and the proposals of early statesmen. In 1790 Alexander Hamilton wrote as follows to the House of Representatives in response to the request for a plan for the disposal of the public lands: "That in the formation of the plans for the disposal of the vacant land of the United States there appear to be two leading objects of consideration. one, the facility of advantageous sales according to the proper course of purchases, the other, the accommodation of individuals now inhabiting the western country, or who may hereafter migrate thither. The former, as an operation of finance, claims primary attention, the latter is important as it relates to the satisfaction of the inhabitants of the western country." * That public lands were used in the satisfaction of public obligations is shown by the fact that settlements with the army were in part effected by means of land-script, and in 1795 it was provided by law that the net proceeds of the sales of land should constitute a portion of the sinking fund for the redemption of the public debt. The financial character of the western lands policy is further suggested by the terms of sale, which were such as to induce the purchase of large tracts of land by land companies rather than the purchase of small tracts by actual settlers. The original price was two dollars an acre, which might be paid by instalments. The result of this policy was to encourage land speculation; it did not, however, succeed in securing any considerable funds for the public treasury, and the practice of granting credits brought with it confusion in public accounts and serious loss to the public treasury. The idea that the public lands could in a direct manner be made the basis of a financial policy, because a source of considerable revenue, was gradually abandoned, and by 1820 it was succeeded by what may be termed the second and permanent policy respecting public lands.

(2) *Use of Land for Development of the Nation.*—The idea which has controlled the administration of the Land De-

* Letter of July 20, 1790.

partment of the United States since 1820 seems to have been that the public domains should be placed in the hands of the occupier in allotments appropriate for cultivation. In this manner it was thought to encourage the agricultural industry and to lead to the development of national improvements. Sale for credit was abandoned, and the price was reduced to one dollar and a quarter an acre. The policy of preëmption, also, had by 1830 taken definite shape. Preemption may be defined as a "premium in favour of a consideration for making permanent settlements and a home." The idea that the land belonged to the people and should be reserved for the occupier became stronger as the years went by. In 1852 it was recognised as one of the political questions of the day, and the Free-soil Democracy placed the following plank in its platform: "That the public lands of the United States belong to the people and should not be sold to individuals nor granted to corporations, but should be held as a sacred trust for the benefit of the people, and should be granted in limited quantities free of cost to the landless settlers."

Congress never went so far as to attempt the extreme realization of this general policy. But when one considers the many ways by which land could be secured—by the Homestead Act, the Tree-claim Act, and other Acts of the same sort—it must be recognised that for a series of years land was practically free to the settler. The idea of land as a basis of fiscal operations thus gave place to the idea that land was the basis of industrial development. The amount of money which the government has secured from the sale of its public lands has been very small as compared with its total expenditures. Thus the aggregate income of the Federal Government during the first century of its life was \$11,684,208,247, while the aggregate income from the sale of public lands during the same period was \$276,476,106, or less than two and one-half per cent of the total.

(3) *Use of Land for Educational and Railway Grants*—While it is true that the land policy of the United States since 1820 has been shaped almost entirely by the interests of the settlers, it is also true that this great property has been used as a fund for the encouragement of education and the development of commerce. By the ordinance of 1775 it was provided that section number sixteen of each township should

be reserved for the support of schools, that is to say, 640 acres out of every township, or an amount of land equal to one thirty-sixth of the entire area. This provision was reenacted in 1787 and has continued in force from that time to the present. Since 1842 section number thirty-six was also granted for public-school purposes, making 1280 acres out of each township, or one-eighteenth of the aggregate area devoted to this purpose.

In 1787 provision was made also for university education by granting to each State an amount of land not less than two townships. It is upon this grant that the State universities of the Western States rest; and although in many cases the land has been dissipated by unwise administration, it nevertheless remains true that this provision is responsible for the establishment and, in large measure, for the perpetuation and success of university public education. In 1866 what is known as the Morrill Bill was passed for the establishment of agricultural and industrial education. By this Act an amount of land was granted to each State equal to 30,000 acres for each senator and representative. It is upon the basis of this law that the agricultural colleges rest. The amount of land granted for common-school purposes has been 67,893,919 acres. The amount of land granted by the Federal Government for the support of State universities has been 1,165,520 acres, for agricultural colleges 9,600,000 acres. This is one way in which the Federal Government has performed its trust of administering the fund of wealth ceded to it by the original States*.

Public lands have also been freely used for the encouragement of inland transportation. During the period in which the State governments were endeavouring to provide canals and railways, many bills were introduced into Congress for the transfer of the proceeds of the public lands to the several States; but with the failure of this experiment, and the consequent rise of private corporations, this thought seems to have been dropped from view. The assistance rendered by the Federal Government in the development of means of transportation has been through the granting of public lands to

* These figures do not include grants since 1880. The statement is arrested with that year in order to enable a comparison between educational grants and grants made to corporations.

private corporations * The amount of land appropriated for canals has been 4,424,073 acres, the amount appropriated for wagon-roads has been 1,301,040 acres; and the amount granted for railroads has been 215,000,000 acres This does not mean that these amounts have been actually transferred with a clear title to individuals and corporations, since in most cases grants were made upon condition that the improvement in question should be completed within a certain specified time. The policy of making grants for railways was discontinued in 1880, since which time the idea that public domains should be reserved for settlement may be accepted as the established land policy of the United States

The manner in which grants were made to canals and railways shows that the government did not lose sight entirely of its own fiscal interest in the public domain Almost universally the practice has been followed of granting alternate sections for a given distance on either side of the public highway The first important grant for railroads was by the Act of September 20, 1850, which gave to the State of Illinois alternate sections of land for six sections in width on either side of the road or its branches † The third section of this Act provided that the lands of the United States within the grant limits should not be sold for less than \$2 50 an acre, the object of this provision being that the government might recoup itself for the lands granted by the increased value of the lands which it retained ‡

In concluding this brief sketch of the land policy of the United States it may be remarked that the original policy was one which could not, from the nature of the case, succeed.

* No distinction is here made between grants which went to States in trust for private corporations and grants which were made directly to such corporations.

† The most important railroad constructed under this Act was the Illinois Central, which was incorporated by an Act of the Legislature of Illinois, February 10, 1851 The fifteenth section of this Act gave land ceded to the State for railroad purposes to this company, the governor of the State being authorized to make a deed or fee therefor to the corporation.

‡ A complete statement of the land grants for railroads may be found in chapter 20 of *History of Public Lands in the United States*, published as Executive Document 47, Part IV, Forty-sixth Congress, 3d Session.

Land does not become a source of revenue until it is brought under cultivation. It has no value and can give rise to no proceeds until it is demanded for occupation. A speculator's money makes poor public income. Even from the point of view of fiscal advantage to the State the policy of sale at low prices to actual settlers is capable of defence. This is the policy which has resulted in the creation of that immense property now the basis of taxation. Out of the aggregate value of tangible property in the United States in 1890, which according to the United States Census estimate amounted to \$65,037,091,197, real estate with the improvements thereon amounted to \$39,544,544,333, and the valuation of railroads and equipment, including \$389,357,289 for street railways, is given as \$8,685,407,323.^{*} This value is the result of a century of industrial progress. Without the land to serve as a basis of industry it would have been impossible, without the land policy it would have been delayed. There is no way of making land a source of public income so quickly as by its sale for actual settlement. The fact that the Federal Government which owns the lands does not use them as the basis for its fiscal system, but grants this source of revenue to the States and minor civil divisions, is no consideration against the policy adopted. To urge this would be to take a contracted view of the situation. The government of these United States includes the State and local governments as well as the Federal Government, and the successful adjustment of the finances of the State and local civil divisions is of as great importance to the Federal Government as to the local governments themselves. The land came originally from the States; it has been returned to the States by the policy which the Federal Government has adopted. It is quite possible that the grants for public improvements were at one time made in too reckless a manner, but when one appreciates that the problem that presented itself to Congress during the first century of the nation's life was the settlement and cultivation of a vast area of wild lands, the use which has been made of the public domain cannot be severely criticised. It at least has the merit of having brought about the desired result.

* Eleventh Census of the United States, volume on Valuation and Taxation, being Part II of *Wealth, Debt, and Taxation*.

CHAPTER II.

REVENUE FROM PUBLIC INDUSTRIES.

CHOICE OF INDUSTRIES FOR PUBLIC ADMINISTRATION.

SPECIAL CONSIDERATION OF PUBLIC INDUSTRIES

- (1) Industries Undertaken Primarily for Revenue.
- (2) Industries in which Revenue is Incidental
- (3) Industries Undertaken Primarily for Service.

THEORY OF CHARGES FOR PUBLIC INDUSTRIES

- (1) Rule for Revenue-bearing Industries
- (2) Rule for Industries bearing an Incidental Revenue.
 - a. The Post-office
 - b. Territorial Railways
 - c. Municipal Railways.
- (3) Rule for Industries Undertaken for Service.

IN considering public industries in their relation to public finances we shall confine ourselves to those practical questions that arise when the subject presents itself to the financier. The first, and perhaps the most important, of these questions pertains to the choice of an industry when a government assumes the rôle of an industrial capitalist or of a business undertaker.

43 Choice of Industries for Public Administration.— Assuming revenue to be the object held in view, the industry naturally selected for public administration should be simple in its organization, and the commodity or service resulting from it should be such as is commonly regarded as a fit subject of taxation. It is somewhat difficult to discover industries that meet equally well these requirements. The mining of salt as it is carried on in Saxony is perhaps as good an illustration of a public industry of this class as can be obtained, although these salt-mines are in fact a part of the public domain, and the propriety of imposing any considerable

payment upon the consumers of salt is perhaps open to question. Tobacco, spirits, and malt liquors are universally regarded as fit subjects for heavy payments. Their growth and manufacture, however, are not sufficiently simple to meet perfectly the requirements of a public business. It may be claimed, also, that these commodities, regarded as articles of consumption, address themselves to the tastes of those who purchase them, and should on this account admit of variety and of high specialization of peculiar qualities. This can only come as the result of experiment and venture, and on this account, unless it be assumed that the consumption of these commodities is in every way to be discouraged, the manufacture of tobacco, spirits, and malt liquors may be more properly left to private undertaking. Or, if this be too strong a conclusion, it at least is true that the superiority of public manufacture of these commodities from the point of view of revenue must be so marked as to set aside objections from the point of view of manufacture.

The financier is not at liberty, however, to determine the question of public industry solely as a question of public revenue. There are many industries which if left to private enterprise would become the occasion of serious social and commercial evils, and it is manifestly proper that the thought of exercising a beneficial control over industries of an evil trend should be held in mind by the government whenever it considers the general question of public undertaking. Mention of a few industries of this class will show clearly the point in mind.

The business of coining money used in trade and commerce, while not universally a public industry, is at present generally recognised as properly assigned to the State. There is no other agency capable of securing to the commercial world a uniform standard of value. Moreover, a sound monetary system requires efficient regulations for the prevention of counterfeiting, a task which pertains naturally to the police. Originally a seigniorage, or toll, was charged for coinage, but at present it is the common practice of commercial states to render this service without special compensation. The service is acknowledged to be a governmental rather than a special service, and is mentioned in this connection as suggesting an industry assumed by the State because of

the evils which would inevitably result from its consignment to private control. For analogous reasons the issue of paper money is also universally recognised as a prerogative of the State, although in this case it is a very common practice for governments to avail themselves of the agency of private corporations. Where money is directly issued by government, as, for example, in the case of the three hundred and forty-six millions of treasury notes now outstanding in the United States, the government receives the profit which accrues to the business of issuing notes. On the other hand, where banking institutions are made the agency for the issues of paper money the revenue derived by the State must come in the form of a tax on the basis of note circulation. In either case, however, the function of issuing notes to be used as money is acknowledged as a governmental function because of the evils that would follow its assignment to private control.

Of more significance to the question under discussion are those industries which tend naturally toward monopoly. The financier must of course rely upon the analysis of the economist for determining what particular lines of business are included in this category, and the reply of economic analysis to this question is that industries which are extensive in character—that is to say, which are subject to the “law of increasing returns”—tend inevitably to monopolistic conditions. While this fact is not final in favour of public ownership and government administration, it does indicate the direction in which government should move in case it is regarded as wise policy to increase its direct revenue. The standard illustration of a business subject to the law of increasing returns is the business of transportation. The railway industry, for example, depends for success upon density of traffic rather than upon attention to details. Its expenses of operation do not increase proportionally with volume of traffic. For these reasons, as would be shown by a careful analysis of the situation, the railway industry takes upon itself the character of a monopoly, and would, on this account, become the source of serious social, industrial, and political evils if left to its normal development. Assuming that these evils would be set aside through government ownership and administration, and, further, that other evils of a different sort would not be introduced by the change, an argument can be

easily framed, quite independently of financial considerations, in favour of a system of State railways. A similar line of argument, also, may be presented in connection with the business of transmitting news by telegraph, with the express business and others of like nature. Analogous arguments, also, though somewhat different in their statement on account of the different social and political conditions of the services in question, might be made with regard to municipal railways, lighting companies, and water companies. These are all, for one cause or another, of a monopolistic character. The public enjoys no guarantee of fair treatment on account of any competition that can affect them. This of itself is adequate justification for some sort of supervision by the State, and may be urged as a reason for the assumption of these businesses by the appropriate grade of government.

Mention of industries that may be selected by the State as a source of revenue, largely on account of the evils which spring from their private management, would not be complete without reference to the manufacture and sale of spirituous and malt liquors. Assuming it to be capable of proof that the liquor problem could be solved along the line of the "Gothenburg System,"^{*} few would deny the appropriateness of extending the functions of municipal government to at least the sale of intoxicants. Whether or not this would increase the revenue to the government above what is now derived from this business in the form of special taxes and licenses may, however, be doubted. Indeed, it is the object of this plan for solving the problem to decrease the industry rather than to increase the revenue, and the financial interests are of such relatively slight account in the discussion of the problem that the question will not claim our further attention in this treatise.

Another reason besides the one given above why industries subject to the law of increasing returns are well adapted to governmental administration is found in the fact that such industries are capable of a high degree of organization, and of control through general rules and comprehensive principles. Their administration is analogous to the administration of a military establishment, in which authority is centralized and orders are executed without question by sub-

* Cf. treatise by Dr. E. R. L. Gould.

ordinate officials. Such an industry is free from confusing details, so far as the rank and file of officers and employés are concerned. Moreover, the questions that present themselves to the administration are not peculiar to the conditions under which they arise, and on this account the answers to such questions will not be restricted in their application. On the contrary, it is likely that the decisions of such questions will be of such a sort that they can be promulgated in the form of general rules, and that the principles underlying them may be used as precedents for subsequent decisions. To put this in another way, the administration of industries which, for the reasons given, tend towards monopoly will naturally crystallize itself into a body of rules, and on this account the extent of the organization or the magnitude of the operations will be no barrier to success. If, now, to these considerations there be added the fact that development in technic rests upon scientific attainment it is evident that we have discovered a class of business undertakings that adapts itself readily to the limitations of the political organization.

It is further desirable that the business selected for government ownership and administration should hold some peculiar and direct relation to the life and development of society. It should pertain to the social utilities or to the collective interests of the people rather than to the appetites and ambitions of the individual. It is admitted that these phrases are somewhat loose and indefinite, but the point is that the business to which the State can with dignity and propriety address itself must be able to trace its results to the civilizing process at the time going on. It must pertain to the conditions under which people live rather than to the process of making a living. One or two illustrations will make this point clear.

The post-office, by which provision is made for the transmission of news and for private communication, is one of the essential conditions of a highly organized society, a fact that receives ample proof by glancing at the following table, which shows the use made of postal facilities by the peoples of a few selected nations. The data are presented upon the authority of von Neumann-Spallart in *Ueberschriften der Weltwirtschaft* for 1880, and although the figures pertain to a date some time past the comparison which they present is still pertinent.

TABLE SHOWING USE MADE OF POSTAL FACILITIES BY THE
PEOPLES NAMED

| Country. | Letters per Inhabitant | Printed Matter per Inhabitant. |
|----------------------------|------------------------|--------------------------------|
| Great Britain | 37.2 | 21 0 |
| France | 14 1 | 15 4 |
| Germany | 15 9 | 12 8 |
| Italy | 7 3 | 6 1 |
| Spain | 4 3 | 2 8 |
| Russia. | 1 5 | 1 1 |
| The United States. | 24 5 | 23 1 |
| Canada. | 14 5 | 4 2 |
| Chile | 2 3 | 2 4 |
| Brazil. | 1 6 | |
| Peru | 91 | .4 |
| Australia | 13 6 | 13.6 |

Most industries known as municipal monopolies, such as water-works, lighting-works, and street railways, are of the same class. Their social or condition-making significance invites in a peculiar manner the attention of government. It is not enough that serious abuses should be avoided in their management, but they should be administered in view of the positive social utilities which from their nature they are able to contribute. The social function of the municipal railway, for example, is to overcome the social evils that result from congested population, which, in its turn, is one of the unfortunate characteristics of modern industrial organization. Equally significant are the social services bound up in municipal lighting and water-supply. To give these industries over to private gain, or to confine public control to the exacting of a fair price for such services as the commercial interest may induce a private company to render, fails to appreciate their social or developmental significance. Railways also are not only essential to a high state of civilization, but the peculiar means of transportation which they afford is a fundamental fact in determining the form of that civilization.* These suggestions are perhaps adequate to make clear what is meant by saying that an industry which from its nature is public in character is one that contributes to the social utilities or the collective interests of a State.

Another mark of a public industry is that the interest

* Cf. C. H. Cooley, *The Theory of Transportation*, in publications of the American Economic Association, Vol. IX.

involved pertains to all citizens without regard to location or to class. This must be the case, since, according to the governmental conception of constitutional peoples, no portion of the machinery of the State should be set in motion except the advantages to accrue therefrom are general in character. In applying this thought to the conditions of modern states there emerges a distinction of great importance. Assuming that the interest involved in a business enterprise undertaken by the government should be as extensive as the jurisdiction of the government itself, it follows that many industrial functions may be assumed by a government of restricted jurisdiction, or by a State of even and uniform industrial development, which are forbidden to governments of more widely extended jurisdiction or to states of a more uneven development. The line of argument thus presented might justify, for example, the advocacy of the ownership and administration of street railways by a municipality, while at the same time one refuses to advocate the ownership and administration of a general railway system by the central government. The interest of the municipality for rapid, safe, and cheap transit is a compact interest, a fact which does not pertain to a national government like that of the United States, with its broad territory and diverse industrial conditions. The rules for adjusting rates in local transit are in no sense complex, since they do not involve in any great degree the relative claims of competing industries. The distinction thus brought to notice is capable of wide application, and is relied upon for the support of many conclusions in municipal finance which may not be tenable in the case of the financial system of the States on the one hand, or of the central government on the other.

A further application of the principle of public financing requires that the government should avoid those industries which invite favouritism on the part of officials, or in which the charge of favouritism from customers will naturally arise. In England and the United States, for example, there is a division of banking functions, and while the business of issuing notes to be used as money is brought under the strict supervision of the State, the loan and discount business continues to be a purely private affair. This must be recognised as a sound rule where government rests on popular suffrage, because the business of lending money or of discounting com-

mercial paper calls for the exercise of careful discrimination. Many other applications of the principle might be referred to, but the above is adequate to show clearly what is meant by the use of the phrase in this connection

The conclusion of the analysis, then, is that industries adapted to public control from which the financier must select in case he deems it wise to extend the direct revenue of the State must meet the three following requirements: first, they must be simple in themselves and capable of administration by comprehensive rules, second, they must be industries in which social evils arise as a result of unregulated private administration, and third, they must involve some comprehensive social interest. There is no single business which presents all of these marks of a public industry except that which has to do with the machinery of commercial exchanges. There is a sense in which all transportation industries, using that phrase in its comprehensive sense so as to include the machinery for transferring values as well as the means for transmitting news or transporting freight and persons, are from their nature public industries

44. Special Consideration of Public Industries—Having thus gone over the ground in a general way, it may be well to speak a little more specifically respecting certain of the possible sources of direct revenue to the State, and in doing this we shall give our attention first to those industries which are undertaken primarily or exclusively for the purpose of securing revenue, second, to those which are undertaken primarily for the purpose of exercising control over them, but from which it is deemed wise at the same time to secure revenue; and third, to those industries which are undertaken primarily for the service which the State may thereby render to its citizens, but in the administration of which the thought of revenue and control may or may not be present. The classification upon the lines thus suggested will not be the same for all peoples. The use made of it in this analysis holds primarily in mind the social, political, and industrial conditions of the United States

(1) *Industries Undertaken Primarily for Revenue*—The most satisfactory illustration of an industry undertaken by the State for a purely fiscal purpose is that of the manufacture and sale of tobacco. What is known as the tobacco

monopoly was established in France by Colbert in 1674, and has been maintained by all the successive governments in France, with the exception of the governments of the Revolution and of the first empire until 1810. Many other states, among them Austria, Switzerland, and Italy, follow in this regard the policy of France. In Germany there is a strong sentiment in favour of a tobacco monopoly, but it may be doubted if it will ever be substituted for the present system of taxation. Before arriving at any conclusion respecting the wisdom of obtaining public revenue in this manner it will be well to consider briefly the administration of a tobacco monopoly, and to compare it with the other methods of securing an income from the manufacture and sale of this commodity, which universally is conceded to be a fit object for heavy payments.

The present tobacco monopoly in France was established and organized by an Act of December 29, 1810, and, although extended and revised by subsequent Acts, remains in its general features the same as when established. This monopoly extends to cultivation, manufacture, and sale. The first step in working out the programme is for the proper officers to estimate the amount of tobacco of French growth which will be needed during the year under consideration. The monopoly is permitted to purchase foreign tobaccos for the purpose of mixture or of manufacture, but is obliged to procure not less than one-fifteenth of its supply of raw tobacco from the home-grown product. As a matter of fact nearly one-third of the tobacco consumed in France is of home growth. The amount of tobacco to be grown is apportioned to the several tobacco-growing provinces, and any one who desires to cultivate this crop must give notice of his intention to the *maire* of the commune before the 1st of March, and a permit will be granted for such cultivation, but the aggregate of these permits must not exceed the amount apportioned to the province. The growing crop is placed under careful supervision in order to make sure that no tobacco is taken for private use or disposed of at private sale. The price to be paid for the crop is determined at the time the assignment for cultivation is made, so that the grower knows before he plants the crop the price he is to receive. For the collection of the crop the government has established a suffi-

cient number of warehouses, so that the grower need not transport his product more than twenty-five kilometres. Such, in brief, are the conditions under which tobacco is grown.

The manufacture of tobacco is likewise a close monopoly. The State owns nineteen manufactories, which give employment to sixteen or seventeen hundred workmen. The process of manufacture does not of course differ from that of a privately administered industry. It is claimed by French writers that State manufacture guarantees a pure article and of good quality; but quality is of course a matter of taste. Indeed, it is possible, the use of tobacco being an acquired habit, that the taste of a people can be cultivated to whatever grade of commodity the government sees fit to furnish, a consideration which is commonly omitted when the French tobacco monopoly is discussed by American writers. The sale of tobacco is carried on by many agents. It may take place in the first instance at the manufactories themselves, or it may be through the means of certain intermediaries. The retail dealers are named by the prefect of the commune where the sales amount to ten thousand francs or less, and by the Minister of Finance if the proceeds exceed ten thousand francs. These permits to sell are accorded by preference to persons to whom the State is in some way indebted, as wounded soldiers or the widows and daughters of soldiers. In this manner it gives to these persons suitable occupation and partially relieves the pension-rolls.

Since the tobacco monopoly is advocated as a means of raising revenue, the student of finance is led to inquire what amount of tobacco is consumed and what amount of money is secured to the State from this consumption. Kaufmann in his treatise upon French finances gives a table which shows in detail the operations of this monopoly from 1811 to 1877*. During this period the excess of receipts over expenditures amounted to 6,362,964,765 francs. At the present time the net proceeds range between 320,000,000 and 400,000,000 francs a year. The general expenses of manufacture and sale amount to about 20 per cent of the gross proceeds, thus giving to the State a profit of 80 per cent upon sales.

It is with some difficulty that this method of securing

* Kaufmann, *Les Finances de la France*, pp. 388-393.

revenue from the manufacture and sale of tobacco is compared with the policy of other countries. In England, where the net income from the tobacco tax amounts to between £9,000,000 and £10,000,000 a year, the growth of tobacco and its manufacture are strictly prohibited, and the government secures its revenue by imposing a duty upon its importation. It does not require any special machinery for the collection of the tax, inasmuch as the duty on tobacco comes to be a part of the general revenue system. The insular position of England renders enforcement of regulations relative to manufacture comparatively easy, and so marked are the fiscal advantages that no serious complaint is heard respecting the prohibition of growth or manufacture within the country.

The position of the United States with regard to this industry is different from that of either England or France, since this country is a grower of tobacco for export. The policy adopted is to impose an excise upon the manufacture of tobacco, and to collect that tax from the sale of revenue stamps. No package can be offered for sale without the attachment of such a stamp. Both the growth of the raw material and its manufacture are recognised as private industries. In addition to the stamp duty a license tax is charged for the privilege of exposing tobaccos for sale. The amount accruing to the Federal Government on account of this tax is about \$30,000,000 a year. The stamp duties together with the license fees are a part of the general scheme of internal revenue. Besides these taxes there is imposed a customs duty upon imported tobaccos. The prime object of this duty is to act as a compensation for the excise duty imposed upon tobaccos manufactured within the country. But the duty becomes a source of considerable revenue on account of the fact that other grades of tobacco than those of home growth are used by the manufacturers for mixing with domestic tobaccos and are demanded by many consumers. In both England and the United States, therefore, it appears that there is nothing peculiar in the method of securing revenue from tobacco. The tobacco tax is a part of the general taxing scheme.

Should one confine his discussion to purely fiscal considerations it would seem that the French method of obtaining revenue from tobacco is preferable to either the English

or the American method, that is to say, more money is collected from the industry, and a monopoly does not seem to impinge upon the prejudices of the people. Such a plan, however, would scarcely be possible in the United States, for, to say nothing of the broad extent of territory and sparse population to which the monopoly must be adjusted, this country does not possess a peasantry of such docile character as that of the Latin-speaking peoples, nor does it have such a considerable number of dependents in whose hands the sale of tobacco could be placed with economy and confidence. The controlling consideration, however, from the point of view of finance would seem to be that, for the United States at least, a tobacco monopoly would be strange to the established and familiar fiscal practices of the people, and on this account would require a separate organization and the drafting of unusual rules of administration. There are many advantages in securing revenue from tobacco by methods followed in other branches of the revenue system.

Other commodities there are besides tobacco which have been made the subject of government monopoly. Thus salt has been a favourite article for monopolization. In Rome the salt monopoly was introduced during the early years of the republic, although the purpose of this seems to have been primarily to protect the consumer rather than to secure a revenue. One of the curious features of the salt monopoly presents itself in the practice of Prussia during the eighteenth century. There was no adequate means of preventing the purchase of foreign salt by the consumer, and, in order to protect revenue, the government determined the amount of salt which each taxpayer ought to consume, and at the close of the year a fine was collected for such portion of the amount as was shown by the public accounts not to have been purchased.* This "salt conscription" was not abolished until 1816. Without entering into any extended consideration of this subject, it is sufficient to say that the general trend of fiscal reform during the nineteenth century has been toward the substitution of taxation of salt for the maintenance of a salt monopoly, except in the case of mines owned by the government regarded as a part of the public domain, or in

* Each person was supposed to consume five pecks of salt, with two additional pecks for each cow.

the event of the abandonment of salt as a proper object of taxation

Another form of monopoly made the basis of public revenue by European states is the public lottery. This has been practised in the past even more than at the present time. According to Cohn, the lottery made its appearance as a fiscal expedient in Florence in the year 1530, and in 1539 Francis I gave permission for the establishment of a lottery on condition of the payment of a bonus to the king. Perhaps the best organized of European lotteries is that of Prussia. In the estimates of the year 1889-90 the sum of 8,287,500 marks was set down as the probable income from the lotteries. The revenue accruing to the State arises from a deduction of 13.75 per cent from all prizes, together with a deduction of 2 per cent for the lottery collectors. The purchasers of the tickets pay also 5 per cent as a stamp duty, together with a clerk's fee. In England the lottery was abolished in 1826 and in France in 1836. The question is subject to constant discussion in Prussia, but thus far the lottery system has been successfully defended.* The question whether or not a lottery should be established is not a fiscal question, its decision turns upon the moral sense of the community respecting this species of gambling.

It is a significant fact that so few purely fiscal monopolies exist at the present time. In the sixteenth century, before taxation was well established, it was a common practice for sovereigns to obtain revenue from royalties upon monopolies. Especially in England under Queen Elizabeth was this fiscal expedient resorted to. Partly on account of the manifest evils of exclusive privileges of all sorts, and partly as a result of the liberal philosophy of the eighteenth century, State fiscal monopolies, either direct or indirect, have been almost entirely abandoned, the tobacco monopoly being the only one of any considerable importance which has held its own. It is believed that this trend of events merits approval. The presumption of modern political philosophy lies against public industries or legal monopolies for revenue and revenue only.

(2) *Industries in which Revenue is Incidental*—While it is true that modern peoples do not look with favour upon public

* For a description of the Prussian lottery cf. Cohn, *The Science of Finance*, §§ 290, 291.

industries regarded solely as a means of procuring revenue, it is also true that the budgets of modern states, and more especially of municipal governments, show a decided increase in this class of revenue. As already remarked, however, the industries from which this revenue accrues are such as demand the attention of government for other than fiscal reasons. The controlling consideration is not revenue, but is found rather in the social evils that follow private management, or in the social advantages that follow public management; and the argument seems to be that, inasmuch as the industry must be placed under some form of governmental control, the financier may as well take advantage of the situation and secure from it a portion of the needed revenue.

The character of the industries to which this consideration applies has also been determined, but it may now be added that, with few exceptions, these industries pertain to the business of transportation. To make this statement true, however, it is necessary to use the word transportation in a broad and comprehensive sense, so as to include the delivery of values and the transmission of intelligence as well as the transportation of persons, goods, commodities, or power. The lines of business thus embraced are the following:

1 Transfer of values (1) Coinage; (2) Issue of notes; (3) Banks of issue, (4) Banks of exchange

2 Transmission of intelligence: (1) Post-office; (2) Telegraph; (3) Telephone

3 Transmission of commodities and power: (1) Irrigation and power canals; (2) Municipal water-works; (3) Municipal lighting companies, (4) Electric-power companies

4. Transportation of goods and persons. (1) Commercial railways, (2) Water transportation companies; (3) Municipal railways; (4) Express companies

It is not claimed that the decision respecting the public administration of one of these industries carries with it a like decision for all the others. Transportation by water, for example, does not seem to be attended by the same evils arising on account of discriminations in rates as railway transportation. The telephone industry, so at least it has been claimed, is a monopoly because of the patents upon which it rests, and of the organization which during the continuance of those patents it has created, not because of its character

as an industry. If it be true, as has been argued in the courts, that an increase in the volume of the telephone business beyond a certain point necessitates a corresponding increase in expenses, this fact excludes the telephone industry from the class of industries industrially monopolistic. We must, however, in this treatise avoid such technical discussion, and content ourselves with pointing out the line of analysis by which an industry which invites public control may be discovered.

A further distinction also must be allowed. In the practice of modern states some of the industries named above are carried on at an expense to the State, as, for example, the coinage of money, for some of them the government aims to impose such charges as will just cover operating expenses, as is the case in the United States with the transmission of letters; while other industries there are from which the government aims to secure a net income available for general expenditures, as, for example, commercial and municipal railways. The principle according to which this line is drawn is not an industrial but a social principle. The character of the service rather than the character of the business determines whether it shall be freely rendered or charged with its own operating expenses, or made the source of a net revenue. The administrative rules which give expression to this principle may vary from time to time, as also for different peoples, but the principle itself abides. The statesman must recognise in it the controlling consideration in formulating a policy for the administration of public industries.

A third generalization may be submitted in this connection. A business which, from its industrial character, or in view of the social services which it renders, might perhaps be intrusted to private administration, may be brought under the administration of the State by virtue of the relation which it holds to other industries. It is natural, for example, that the transmission of intelligence by wire should follow the rule adopted by the transmission of intelligence by letter. The post-office and the telegraph play into each other's hands in such a way that the two businesses ought to be merged into one. Such at least is the opinion of the great majority of the nations. Another illustration of the same point is furnished by the relation which exists between commercial railways and the

express business Where the former are under the management of the government the business of the latter is divided between the freight department of the railways and the post-office department Where the former are owned and administered by private corporations the express business likewise is a private industry Other illustrations might be given were the point a difficult one to understand.

(3) *Industries Undertaken Primarily for Service*—In this category there falls a considerable number of public undertakings, but the subject is so closely interwoven with the general theory of governmental functions that it can with difficulty be separated for purpose of financial discussion The most important of these services, whether regarded from the point of view of social significance or from that of the amount of money which it demands, is that of education In Michigan from 60 to 70 per cent of local taxes is for the support of the public schools There is here no thought of a special service, and there is no effort made to assign the cost to the individuals who receive the benefit Only in the case of students who reside outside the district taxed for support of the schools is there any thought of a tuition charge. This at least is the general practice in the United States so far as common-school education is concerned With the higher grades of education the custom is not uniform. In some communities a charge is made for students who enter the high schools, or, if not for all students, for such of them as select to follow the less frequented branches of instruction. Latin and Greek, for example, are sometimes made the subject of a special charge, on the ground that their study is a personal and not a general concern The State universities, also, in one way or another, secure payment from the students who attend them, and thus relieve, in part, the public treasury from the full maintenance of this grade of education The principle that runs through all this is easily determined: what is conceived to be of general interest is paid for out of taxes; what is conceived to be of personal interest is paid for by the individual; what is conceived to be of mixed interest is supported by contribution from both the public and the private purse The discussion forces its way back to the character of the service; the financial organization can easily adjust itself to whatever view prevails respecting the service.

What we have said of education is true of a considerable class of public undertakings, and no new principle would emerge as compensation for our labour were we to consider each of these in detail. The truth seems to be that industries undertaken for service possess no financial character when regarded from the point of view of income. If the financier is to have any voice respecting them it must be because these services are the occasion of expenditures to be met out of the proceeds of general taxes. As a topic for discussion in the theory of expenditures they are most significant, but they possess no independent standing in a theory of income. The revenue to which they give rise, in case any charges are preferred, must be justified as an exception to the rule that general services should be assigned for their support to the proceeds of general taxes.

Certain industries undertaken for service differ in one particular from education, which we have accepted as in the main typical of this class. Reference is here had to those undertakings, such as forestry, that give rise to a by-product that may be sold, or to those, such as irrigation, that necessitate a commercial transaction in order that the service may be performed equitably as between citizens. In those cases there must be a price, and the question of revenue comes to be a matter of direct fiscal importance. The fiscal interests in such undertakings, or, better, the limitation upon the fiscal interest imposed by other considerations, will emerge as we consider the theory of public charges.

45. Theory of Charges for Public Industries.—In discussing this question the student must bear in mind that the charge for a public service is neither a tax nor a competitive price. Nor can it be regarded as a combination of a tax and a price. It is rather a charge made in view of the purpose for which the industry in question is undertaken, and must be determined by all those considerations that present themselves under the phrase "public utility." So divergent are the conditions under which industries are assumed by the State that charges may vary in their character all the way from a fee, the object of which is to facilitate some branch of the administration, to a price that imposes all that the service or traffic is able to bear. Indeed, the question of price for a public service plays over the entire gamut of social

and political considerations, ranging from the conception of a gratuity to that of a charge designed to destroy certain activities regarded as socially injurious. The outlook from this question presents a philosophy of its own, but in this elementary treatise it will not be possible to grant it the consideration which either its interest or its importance demands. We shall content ourselves with presenting in outline a theory of public charges.

The three classes of public industries recognised by our analysis are those undertaken for revenue, those in which revenue is incidental, and those undertaken for service. To each of these classes of industries there pertains a rule for the adjustment of prices.

(1) RULE FOR REVENUE-BEARING INDUSTRIES.—So far as industries undertaken for revenue are concerned, as, for example, the tobacco monopoly, the rule to be followed is that of a monopolistic adjustment of the price, and the actual price charged will be the maximum commercial price modified by such social considerations as pertain to the case. Greater difficulty inheres in the selection of an industry to be made the source of revenue than to the adjustment of charges after the industry is selected, for the adjustment of charges is largely a matter of experiment, and must be determined in view of the recorded results of a range of prices over a series of years. In the application of this rule, however, many of the considerations which control the assessment of taxes must be acknowledged as pertinent in the arrangement of a schedule of prices. Tobacco, for example, is of many grades, and each grade may be regarded as assigned to a definite class of incomes. Now as in the case of income taxes the rate of payment may vary for the several grades of income, so in the adjustment of prices some regard may be had to the ratio of the price to the size of the income from which it is likely to be paid. But in practice this consideration cannot be pressed very far, since the higher range of payments can be easily evaded by those for whom they are intended through the purchase by them of goods of inferior quality. Theoretically, however, it is necessary to recognise that the rule of charging what the traffic will bear may be modified by considerations of public utility.

(2) RULE FOR INDUSTRIES BEARING AN INCIDENTAL

REVENUE—The more difficult analysis respecting a schedule of charges for a public industry presents itself in connection with those industries in which revenue is more or less incidental to service. These industries, it will be remembered, are such as determine in large measure the conditions of living for the great body of the people. The post-office, for example, while properly classed as an industry undertaken for the service which it renders, is nevertheless administered with a careful regard for revenue. Public railways, also, both territorial and municipal, while they may permit more freedom to the desire for a commercial profit, are acknowledged to be industries in which social considerations properly influence all questions of development and administration.

(a) *The Post-office.*—The rule for regulating postal rates seems to be pretty well established, and, allowance being made for slight modifications to meet the variety of social and political opinions entertained, to be generally followed by civilized nations. It may be expressed as follows: the aggregate of receipts must cover the aggregate of cost; but in the attainment of this result greater regard should be had to volume of service rendered than to the charge upon the unit of service. Postal charges present three peculiarities: In the first place, rates are remarkably low; two cents, for example, for the collection, transportation, and delivery of a letter. In the second place, the charge is uniform irrespective of distance; in the United States, for example, two cents is asked whether a letter is carried three miles or three thousand miles. Involved in this uniformity of price is the significant result that the profit accruing to the service in a densely populated portion of the country is used to cover the deficit which arises on account of rendering a similar service in portions of the country more sparsely settled. Thus the excess over cost in New York and Ohio goes to pay part of the cost for Kansas and Colorado. The third peculiarity in postal charges is that the classification of packages to which the schedule of uniform rates is applied is determined rather with a view to protect the service against unduly heavy packages than for the purpose of harmonizing the charge with the cost. Not only is the postal service an exclusive monopoly within the limits of the packages it chooses to handle, but it adjusts its charges so as to make careful selection of the packages to be handled. There

is perhaps no better illustration of a social solution of a financial problem than the one presented by the postal service

The familiar history of the postal reform which began in England in 1840, and which subsequently spread to all civilized peoples, need not be here repeated ^b. The reduction in charges to a uniform penny postage payable in advance was followed by a corresponding expansion in the service, and while the financial results did not during the first years [†] conform to the expectations of the extreme advocates of the measure, the many incidental advantages of a highly organized and comprehensive postal system are so marked that the wisdom of the measure is no longer questioned. One point only respecting it demands attention. What, it may be asked, is the secret of the success of a uniform rate irrespective of distance [‡]? The significance of this query lies in the fact that many writers, interpreting the success of this rule when applied to the transmission of letters to mean that an industrial service can be rendered without regard to specific cost, have argued for its application to all sorts of communal or social services [§]. The mistake involved in such a generalization lies in the assumption that the postal charge is determined without regard to cost. The fact is that the cost incident to the postal industry consists in collection and delivery at terminal points, the expense of transportation being in the United States less than one-third of total expenditures. It is the peculiarity of the industry rather than of the rule of charges which warrants a uniform rate irrespective of distance. So long as this is held in mind there is no danger of a false application of the principle.

(b) *Territorial Railways* —The problem of railway rates has not, like that of postal charges, passed beyond the domain of current discussion. This is in part due to the fact that railways are universally regarded as a source of profit, to companies when privately owned, to the State when public property; but it is in larger measure due to the fact that the social significance of railways is not yet clearly under-

* For convenient references compare Bastable, *Public Finance*, pp. 190-197.

† Cf. McCulloch, *Taxation and the Funding System*, p. 330.

‡ Cf. Cowles, *A General Freight and Passenger Post*,

stood The problem of railway rates is a problem by itself, and stands as one of the most important of the unsettled problems of the day Of the many questions that arise there seems to be harmony of opinion respecting two only It seems to be universally conceded that the first step in drawing a schedule of rates lies in an appropriate classification of the services rendered, and it seems to be equally well established that no invidious discrimination can be allowed between individuals or places in the transportation of goods or persons. Beyond this the practice of states shows little that is clear, definite, and systematic

The Germans have perhaps proceeded farther in the direction of a scientific solution of this problem than any other people, and this they have done, not so much by a study of rates as by an attempt to organize the interests that are involved in the adjustment of rates* We shall not undertake to characterize this organization, but venture the remark that the relation of the railway itself to the clients whom the railway serves must be clearly appreciated before the essential relations and social principles can be discovered upon which to base a schedule of railway rates Assuming railways to constitute a public property, rates should be proposed by the shippers and accepted or rejected by the government In the proposals submitted by the shippers (we assume the shippers to be properly organized) the primary social interests will find adequate expression, in the acceptance or rejection of the proposals by the government not only will the general social interests be guarded, but the financier also will be enabled to provide for such income over and above operating expenses as it may seem proper that the business of inland transportation should contribute to general revenues It thus appears that the problem of railway rates on State railways, so far from leading to a discussion of an appropriate price to be adjusted by commercial rules, comes to be a question of the organization of commercial interests by means of which a just schedule of charges shall emerge, and with this suggestion we drop the question.

* A concise and fairly accurate account of the German organization will be found in Meyer's monograph *The Adjustment of Railroad Rates in Prussia*, Vol. XI, *Transactions of the Wisconsin Academy of Sciences*.

Sufficient has been said to suggest that the public ownership of railways opens up a domain of industrial integration and governmental administration with which English-speaking people are not familiar

(c) *Municipal Railways*—A municipal railway or tramway is peculiar in the character of the traffic which it carries. The social results of a passenger traffic, especially if confined to the limits of a municipality, are easily traced and may be statistically measured. Moreover, this traffic, inasmuch as it involves few terminal expenses, and is entirely free from the cost of loading and unloading, is a most remunerative one, and the returns from it increase enormously in proportion to density of traffic. Under such circumstances there is no reason why the rate should not be adjusted with some regard to the revenue that may be derived from it. For it is a well-known fact that a price which becomes a burden to any class in the community, the importance of the service being taken into the account, will tend to deplete revenue by curtailing use, while the price at which cars are used to their full capacity will probably yield a large return upon the cost of construction. Now it is evident that, under such conditions, the financier is furnished with ample latitude for harmonizing the social and the financial interest. Indeed, it is scarcely conceivable that the financial interest, which looks to street railways and analogous industries for a very considerable portion of its general revenue, can be jeopardized by the adjustment of rates in harmony with the social function which such railways perform. Not only may the price for transportation be low, but it may discriminate in favour of long-distance travel, for only under such conditions can the demand of industry for a high degree of centralization and the demand of healthful living for room, light, and air be harmonized.

We may then conclude that the process of determining the price to be charged for industries in which revenue is more or less incidental consists in adjusting the financial purpose to the social end for which the industry is undertaken. This is neither very definite nor conclusive, but it at least has the merit of providing the proper approach to the question in hand.

(3) RULE FOR INDUSTRIES UNDERTAKEN FOR SERVICE.—

It remains to consider the determination of price for industries undertaken primarily for service. With industries of this class it is rather as a factor in administration than as an assertion of either a primary or incidental financial interest that the financier contemplates the adjustment of a price. For the purpose of illustrating this point of view we shall refer again to public forestry and public irrigation. The establishment and maintenance of a system of forestry is designed to render a general and not a particular service, and there can from the nature of the case be no personalization of the price. That which bears the price is the by-product of the industry, and not the main service. It is this fact which distinguishes forestry and analogous undertakings from industries like the railway and the post-office, and an appreciation of the situation suggests at once the rule for the adjustment of the price of such products as fall into the hands of the government for sale in connection with its administration of the main service. The lumber, charcoal, and ash products which the forestry division sells is not all the lumber, charcoal, and ash products placed upon the market for sale. This being the case, to dispose of the forestry by-products gratuitously, or to place them on the market at less than their commercial price, would subject private dealers to a competition they could not well sustain. The government must demand the ordinary commercial price, but in determining that price it must reckon its own output as a part of, and not as supplemental to, the regular orderly supply. So far as principle is concerned this is all there is to the question. This rule applies to prison-made goods, which are to be regarded as a by-product of a reformed prison administration. Indeed, it is of general application to all cases where the government is in receipt of a product of value and yet does not see fit to monopolize the process of production.

The rental to be charged for the use of water from a public system of irrigation presents a slightly different case. The water-supply is limited when compared with the uses to which it may be put. Moreover, for the cultivator the rental forms an element in the cost of cultivation. There are the controlling facts for determining the water rate. In the first place the rate must be such as to charge the cost of con-

struction, maintenance, and administration to the industry created by the system of irrigation, while in the second place the rate must be so adjusted as to permit a free use, while guarding against a lavish use, of water. This is a case in which the price comes to be the determining factor in administration. It is the means by which the service is fairly apportioned to those for whom it is rendered.

This rule of price is the one that should be followed by municipalities when they undertake the supply of water or light. All that the municipal government need trouble itself about, at least in ordinary cases, is that the service does not become a permanent burden upon general taxes, and that, while encouraging a generous use, the facilities which the city provides should not be wastefully employed. In a rough way one may say that the price varies with the natural supply, from which one may see how useless is the rule that the price for water or light shall be adjusted to the average price of cities of the same size. Each city has a problem of its own that must be solved in view of the engineering elements which it presents. The price charged for the service rendered is an element in administration and has primarily nothing to do with the financial organization of the municipality. The administrative price may, or it may not, procure a clear revenue for the treasury, the test of its proper adjustment is found in the manner in which the citizens make use of the service rendered.

Our conclusion, then, respecting the price of industries undertaken by the State is as follows: Industries undertaken primarily for revenue will adjust their prices according to the rule of commercial monopolies, industries in which revenue is incidental to service will seek for a schedule of prices in which the social and financial interests involved are harmonized; industries undertaken primarily for service will recognise the price either as an incident in administration, when commercial considerations must control, or as a factor in administration, when commercial considerations may be ignored.

BOOK II.

TAXATION

CHAPTER I.

GENERAL CONSIDERATIONS RESPECTING TAXES.

CONCERNING THE METHOD OF TREATMENT.

CONCERNING THE GENERAL NATURE OF A TAX.

DEFINITION OF A TAX FROM THE LAWYER'S POINT OF VIEW.

- (1) Must be for a Public Purpose.
- (2) Must be Levied in a Spirit of Equity.
- (3) Must Conform to Established Rules

DEFINITION OF A TAX FROM THE THEORIST'S POINT OF VIEW.

- (1) The Purchase Theory of a Tax.
- (2) The Benefit Theory of a Tax
- (3) The Contributory Theory of a Tax.

ANALYSIS OF THE TAXING POWER.

- (1) Character of the Power
- (2) Grants Bestowing the Power.
- (3) Limitation upon the Power.

CONCERNING THE DUTY TO PAY TAXES.

- (1) Difficulties of Administration due to Foreign Residence.
- (2) Difficulties of Administration due to Difference of Business Interests

PRINCIPLES OF TAX EXEMPTION.

THE chief source of revenue for modern states is found in taxation, and this will continue to be the chief source of revenue as long as the institution of private property in productive agencies receives the approval of mankind. It is on this account that a study of the principles of taxation, and of the rules of the apportionment, the levy, and the collection of taxes, constitutes the most important part of the Science of Finance. It would be a mistake, however, to so emphasize the importance of taxation that its relation to the other parts of the fiscal system is lost to view. Not only would this lead to an

imperfect conception of the financial organization of modern states, but it would render a study of taxation itself unnecessarily difficult, since that study would then be deprived of the broad basis upon which certain of the most important principles of taxation rest. Taxation is undoubtedly the most comprehensive problem in the Science of Finance, but it does not fill the domain of that science.

46. Concerning the Method of Treatment. — One acquainted with the general literature of the subject is familiar with the different methods adopted by English and Continental writers in their treatment of the problem of taxation. Most English writers include what they have to say on this subject in their treatises upon Political Economy. John Stuart Mill, for example, after bringing his system of private economy to a logical close, adds a fifth book which he entitles *On the Influence of Government*. Taxation is included in this book as one among several ways in which the action of government may interfere or possibly modify the working of economic law.* There are, it is true, a few

* "Some observations, however, may be usefully bestowed on the nature of the considerations on which the question of government interference is most likely to turn, and on the mode of estimating the comparative magnitude of the expediences involved. This will form the last of the three parts into which our discussion of the principles and effects of government interference may conveniently be divided. The following will be our division of the subject.

"We shall first consider the economical effects arising from the manner in which governments perform their necessary and acknowledged functions.

"We shall then pass to certain governmental interferences of what I have termed the optional kind (i.e., overstepping the boundaries of the universally acknowledged functions) which have heretofore taken place, and in some cases still take place, under the influence of false general theories.

"It will lastly remain to inquire whether, independently of any false theory, and consistently with a correct view of the laws which regulate human affairs, there be any cases of the optional class in which governmental interference is really advisable, and what are those cases.

"The first of these divisions is of an extremely miscellaneous character, since the necessary functions of government, and those which are so manifestly expedient that they have never or very rarely been objected to, are, as already pointed out, too various to be brought under any very simple classification. Those, however, which are of principal importance, which alone it is necessary here to consider, may be reduced to the following general heads.

separate treatises on financial questions, such as McCulloch's *Taxation and the Funding System*, Peto's *Taxation Its Levy and Expenditure, Past and Future*, Levi's *On Taxation How it is Raised and How it is Expended*; but these works are separate in form only and do not recognise the existence of a Science of Finance as an independent study. Mention should be made also in this connection of Bastable's *Public Finance*. This work, which appeared in 1892, is the first comprehensive treatise in the English language which follows the Continental form of treatment, but it fails to impress upon the student that sense of solidarity which alone may be urged as an apology for an independent treatment of financial questions.

Inasmuch as our own treatise adjusts itself in the main to the social organization developed under the influence of English common law, and is in harmony with what the author believes to be the conception of liberty in process of realization by the English-speaking peoples, it may be well to explain why, in so significant a matter as the classification of the sciences which deal with social relations, approval is granted to the Continental rather than to the English method of treatment. Not only will this explanation lead to an interesting analysis considered by itself, but by means of it the point of view from which our discussion is undertaken, and which is believed to be the point of view to which all modern nations are arriving in their social and political development, will be yet more clearly apprehended.

What is technically known as English political economy, being the system of thought which regards taxation as an interference by government with the normal working of economic forces, reached its highest possible development in the treatise of John Stuart Mill. The assumption of *laissez-faire* as the general principle for the guidance of public policy served as an obstruction to further development, since it did

"First, the means adopted by governments to raise the revenue which is the condition of their existence

"Secondly, the nature of the laws which they prescribe on the two great subjects of Property and Contracts

"Thirdly, the excellences or defects of the system of means by which they enforce generally the execution of their laws, namely, their judicature and police." (Mill, *Principles of Political Economy*, Book V, Chapter I, § 3.)

not allow candid inquiry into the rational form of commercial and industrial organization. Under the influence of this doctrine it was difficult to perceive that a normally adjusted society could make demands on government beyond a demand for the protection of person and of property. The placing of the State within the domain of industry for the purpose of rendering a direct service, or, what is more to the point, of maintaining those conditions in which voluntary association can work to the advantage of the community, was not regarded as worth the serious consideration of the classical school of economists.

It is not strange that this should have been the case when one notices the conditions under which the classical economists produced their works. Adam Smith, the first great master, wrote prior to 1776. The work of Malthus and of Ricardo was done under the influence of the narrow conception of the first quarter of the nineteenth century. Senor, who gave form to the tenets of the school, did his thinking before 1830 and was strongly impressed by the individualistic claims of the possessing class. Even Mill, who reduced the economic thought of the previous hundred years to systematic form, and whose book appeared in 1846, wrote before machinery had achieved its final victory, and before corporations had exposed their true significance. It thus appears that the social and industrial conditions which presented themselves to the minds of the classical writers of English political economy were in many respects different from those which emerged subsequent to 1850. The problems to be solved were different, and the evils against which it was thought necessary to guard society were different. These writers did not, and indeed could not, adequately appreciate the centralizing tendencies of machinery; nor could they perceive that great industries, unless subjected to proper control, might come to exercise a tyranny as baneful as political tyranny. It was reasonable, therefore, for these writers to support the theory of restricted governmental functions.

To advocate the doctrine of *laissez-faire* at the present time in the same way as it was advocated by English economists would, to express it mildly, be an anachronism, and the reason why modern writers have undertaken to reconstruct economics is that reconstruction is necessary in order to ad-

pose now served by the term taxation. This being the case, the essential characteristic of a tax may be discovered by observing what is common to all the words which have been pressed into service by successive fiscal administrations. Professor Seligman has made an admirable collection and classification of these terms. His presentation of the subject is as follows:

"This historical process is well illustrated by etymology. If we look at the various terms applied to what we to-day call a tax we shall find every shade of the development reflected not only in the words used in former centuries, but in those still employed to-day. There are no less than seven different stages in this etymological growth.

"The original idea was that of gift. The individual made a present to the government. We see this in the mediæval Latin term *donum* and in the English *benevolence*, which was used far into the middle ages. The second stage was reached when the government humbly implored or prayed the people for support. This is the meaning of the Latin *precarium*, used for many centuries on the Continent, as well as of the German *Bede* (from *beten*, to pray). The *Landbede* was the term applied to the land tax in the German states until quite recently. With the third stage we come to the idea of assistance to the State. The individual felt that, if not making a gift, he was at least doing the government a favour. This idea is expressed in the Latin *adjutorium*, the English *aid*, and the French *aide*, which was at one time used for all kinds of taxes. The same idea is discernible in the English *subsidy* and *contribution*. It has survived in the German term for a tax, *Steuer* (*steuern*, to help), and in the Scandinavian *hjælp*. In France *contribution* is even to-day commonly used as synonymous with tax.

"The fourth stage of development brings out the idea of sacrifice by the individual in the interest of the State. He now surrenders something for the public good. This is seen in the old French *gabelle*, in the modern German *Abgabe*, and in the familiar Italian *dazio*. In each case the citizen gives or sacrifices something. With the fifth stage the feeling of obligation develops in the taxpayer. The English *duty* was not originally restricted to its present narrow meaning in the United States. Here it is usually applied to import taxes.

and sometimes to the internal revenue taxes. But even to-day in England the term includes some of the most important so-called direct taxes, like the inheritance tax and the income tax. It is not until the sixth stage is reached that we meet the idea of compulsion on the part of the State. We see this in our *impost* or *imposition*, as well as in the French *impôt* and the Italian *imposta*. Although we limit the term to a certain kind of tax, the French use it as the generic epithet *par excellence*. The same idea is seen in the German *Auflage* (something 'laid on') and *Aufschlag* (something 'clapped on'), frequently used at present for certain indirect charges on commodities.

"With the seventh and final stage we reach the idea of a rate or assessment, fixed or estimated by the government without any reference to the volition of the taxpayer. We see this in the mediæval English *scot* (to be 'at scot and lot'), which is nothing but the German *Schoss* or the Scandinavian *skatt*. It is seen in the German *Schatzung* (or estimate), which was used in the early part of the century. Above all, it is recognised in our *tax* (*taxare*, to fix, to estimate), the French *taxe*, the Italian *tassa*, and the English *rate*. It is worthy of note that in the middle ages 'tax' always meant a direct tax, for which a regular assessment list or schedule was made"*

The only conception which all the terms named above hold in common is that revenue from taxation forms a derivative and not a direct revenue to the State. The significance of this phrase has already been considered in connection with the classification of public revenues. It means that the fund to which the State appeals through taxes is the income of persons or of associations of persons, and is by this means to be distinguished from the income of the State conceived as a proprietor or as a corporation engaged in some industrial pursuit. A system of taxation, therefore, implies the institution of private property; it presumes prosecution of private industry; and the tax, this being the word now most commonly employed, comprises that portion of private income given over to the State for expenditure. The manner of securing the payment, the rules according to which the payment is assessed to persons or to associations of persons,

* Seligman, *Essays in Taxation*, pp. 5, 6, 7.

the argument relied upon for justifying the payment, or, indeed, any of the considerations or attendant circumstances peculiar to time, place, or stage of development, are not essential to the conception of a tax. It is true one cannot proceed very far in an analysis of any question of taxation, or in a discussion of administrative or financial adjustments, without being forced to recognise many qualifying ideas; but this does not modify in the least the conclusion that the essential characteristic of a tax, the only one, indeed, of universal application, is that it forms a derivative revenue to the State

Modern definitions of a tax almost universally insert the statement that the payment from a subject to a sovereign is a coercive and not a free-will payment, and, according to modern theories of political science, such a qualification is eminently proper. By the phrase coercion, however, should be understood legal coercion, and not the coercion which results from the recognition by an individual of definite wants, or from the pressure of public opinion, or from the sense of duty, which in a loose use of language might be included under that term. Much confusion has been introduced into the subject by the loose use of this word coercion. Professor Seligman would hardly care to be understood, when he says that the "idea of compulsion on the part of the State" was not introduced until what he terms "the sixth stage" was reached in the development of the idea of a tax, as implying that before this time governments exercised no pressure upon citizens in securing from them payments. Such a statement would be manifestly untrue. His meaning undoubtedly is that it was necessary for private rights in productive property to have been fairly well developed before a sovereign government could be safely intrusted with the public right of making compulsory demands upon its subjects. The legal conception, therefore, which is an essential quality of modern taxation, implies the development of certain restraining principles in the exercise by the State of the taxing power.

The full significance of taxation as a compulsory payment will not be apparent so long as the only relation held in mind is that which exists between the subject and the sovereign. The justification of the compulsory payment is not so much to enable the State to secure adequate revenue as that the

State in securing its revenue may deal equitably between its subjects. The service of the State is a common service and contributions for its support must in justice be made by all. Were the sense of social obligations sufficiently developed to insure a universal contribution, and one which the sense of justice would acknowledge to be relatively equitable between citizens, it would not be necessary for the State to employ coercion. It is because this is not the case that a tax comes to be a coercive payment, and it adds much to our conception of a tax, and suggests the spirit in which all questions relative to taxation should be discussed, to recognise that the exercise of coercive power by the State in the matter of public revenue is in response to the ethical sense of the community, which demands equitable payment from all citizens. The coercion to which reference is made in defining a tax is the legalized coercion of constitutional peoples, and in this sense is of relatively modern development.

48. Definition of a Tax from the Lawyer's Point of View.—Pressing now our inquiry beyond the conception of a tax approved by all writers on finance, it will be found that the diversity of opinion respecting the nature of a tax arises from the fact that the definitions which present themselves are either adjusted to some peculiar legal code, or they are coloured by some peculiar rule of apportionment or special theory of social organization. It may be well to consider separately these two classes of variations in the conception of a tax, for each bears with it certain qualifying ideas or social and political tendencies necessary to a full understanding of the nature of a tax as that word is used by modern peoples. The legal definition of a tax is the first which claims attention.

Confining our analysis to the accepted principles of American law, it is observed that a coerced payment from the subject to the sovereign must meet three conditions in order to be recognised as a tax. These are as follows:

(1) This payment must, in the first place, be for some public purpose. This requirement rests upon the very nature of the modern State, which, if it be not government by the people, is universally government for the people. This has been clearly shown in connection with the discussion of budgets and budgetary legislation. The assessment and col-

lection of moneys for private ends is a tyrannical act not contemplated by the constitutional organization of the State. The law goes even further in the application of this principle. Not only would a demand for money for private purposes be an abuse of the taxing power, and so, technically, no tax, but a demand for money for public purposes in excess of a just demand would be accounted a robbery under the form of law *

It is one thing, however, to lay down a legal principle, and quite another to provide for the enforcement of that principle; and the nature of this right of the citizen against the State will not be seen until one inquires what remedy is open to the citizen in case a government make improper and excessive demands. This question leads to an important distinction. Although fundamental law may recognise a compulsory demand for revenue to be an encroachment upon the rights conferred upon citizens by the institution of private property, it does not provide, except in extreme cases, for legal redress in case of a wrong, that is to say, the courts, speaking generally, are powerless in the premises. The decision as to what constitutes a public purpose is intrusted to the legislature, and the courts universally assume that any law which the legislature may pass is passed in the interest of the public. The remedy provided for the redress of a wrong of this sort committed by the legislature is the political and not the legal remedy. It is at the polls and before the tribunal of the people, and not in the courts and before a jury, that such cases are tried. This distinction between the political and the legal remedy must be held constantly in mind.

(2) A coerced payment from the State to the sovereign must, in the second place, be levied in a spirit of equity and justice as between the subjects in order to conform to the modern legal conception of a tax. This, it is true, is nothing peculiar to taxation, it is rather an application to taxation of a general governmental principle. The government should

* The distinction between a tax and a tribute is that the former collected by a government from its own subjects is limited to carefully defined needs of the State, while the latter collected by a conquering people from a subjected nation bears no relation to the amount of justifiable public expenditures. When a government abuses its taxing power by excessive demands it treats its subjects as a conquered dependency.

have regard to equity as between citizens in the matter of taxes for the same reason that all of its dealings should be conducted in the spirit of fairness and justice. This necessity, as has already been pointed out, is the apology which the State offers for the exercise of coercive power in the matter of taxation, from which it follows that should the State levy or collect an unjust or an inequable tax it betrays the trust which has been reposed in it. Equity of payment as between citizens is a fundamental characteristic of taxation among constitutional peoples. It is on this account that so large a share of the study bestowed upon this subject inquires respecting principles of equity and justice.

This legal quality, however, like the one mentioned above, must rely for its realization upon the political rather than upon the legal remedy. Courts have sometimes ventured to express an opinion as to whether or not a tax is levied for a public purpose, but should a court undertake to say that a particular system of taxation is without the warrant of law because it fails to realize equity as between citizens, except, indeed, this opinion rest upon some explicit expression in the fundamental law of the State, it would be guilty of an encroachment upon the reserved functions of the legislature. The remedy for the inequable tax lies in the political organization of the State, and for this reason is it especially important that public opinion should be intelligent and sensitive to moral considerations in all matters pertaining to taxation.

(3) The demand of a State for money in order to be rightly accounted a tax must, in the third place, be made according to established legal rules. This legal characteristic of a tax has nothing to do with general principles, but its recognition is nevertheless of great importance. Among the marks of a good revenue system to which attention has been called mention was made of the necessity of harmony in all its parts. The laws out of which a revenue system is constructed are enacted by many different legislative bodies, at many different times, and with the stress of argument placed upon some peculiar interest which at the time happens to present itself. Should the vote of the legislative body be alone adequate to insure the legality of such law confusion of statement and contradiction of principle would surely re-

sult For this reason the duty is imposed upon the courts in the United States of interpreting the phraseology of laws, and of denying the name of a tax to a levy which has not been made according to established legal requirements

This third legal characteristic of a tax has a yet broader application. There is perhaps no other constantly recurring public act which lies so closely to the interests of the people as the levy and collection of taxes, and, notwithstanding the political remedy against the abuse of the taxing power provided in the organization of popular government, private industry would not feel that safety essential to a healthy and active life were no other safeguard against the arbitrary acts of government provided. No power or right can be properly understood without recognising that it is limited in its exercise by corresponding rights which in a sense stand opposed to it. This statement applies equally to public and to private rights, and is of especial pertinence to problems in taxation. It is undoubtedly true that a tax is a coercive abstraction of private property, but this statement itself implies the institution of private property, and the general right of the State in matters of taxation must be interpreted in the light of the fundamental privileges which the law of private property guarantees the citizen. When, therefore, it is said that a tax must be levied according to legal requirements there is implied by the statement, not only a code of parliamentary procedure, but a system of well-defined private rights.

Still another application of this third characteristic of a tax presents itself, which, however, is of more direct application to a federated union like the United States than to a centralized government. According to American law, each grade of government enjoys a definite though restricted jurisdiction, and in framing tax laws it is necessary that these several jurisdictions be strictly conformed to. Failure to observe this rule would give rise to no difficulty should all industries from which citizens derive an income be confined in their commercial relations to the political jurisdiction of the government to which they make payment. But this is not the case. The development of inland transportation has destroyed the local market for large numbers of industries, so that there is no identity between the political jurisdiction of States and what perhaps may by analogy be termed the

commercial jurisdiction of industries. An insurance company, for example, having its headquarters in one State secures revenue from policies sold in other States. A manufacturing corporation also sells goods to the citizens of other commonwealths than the one which grants it a charter. These are but illustrations of the complexity which must necessarily arise when the several States undertake to secure revenue from the industries lying within their respective jurisdictions. There must be of course some fundamental law respecting the relative rights of the several centres of taxing authority, and no better way has as yet been devised than laying down certain fundamental principles or rules to which all laws levying taxes must conform, and of granting to the courts the right of determining whether or not such rules are conformed to.

From the above it appears that there is ample room for controversy respecting the legal characteristics of a tax, as also for the development of the law of taxation. There will of course arise differences of opinion between the theorist and the publicist, but it is essential that one who undertakes a theoretical treatment of the problems of taxation should do so with the full appreciation of the limitations which the established body of law imposes upon any suggestions which he may have to make. From the standpoint of law a tax may be defined as an enforced payment levied by government for public purposes and levied according to established legal requirements.

49. Definition of a Tax from the Theorist's Point of View — The assistance to be derived from a study of the nature of a tax as reflected in definitions of theorists is of an entirely different sort. Such definitions of theorists do not exhibit the facts of social conditions during the period in which they claim the attention of publicists, but rather the ideals and purposes of the times in which they were made the subject of controversy. They have on this account an important historic significance and, like all material of history, assist the student by rendering possible a comparative analysis. From the point of view of strict logic all these definitions are open to the criticism that they include in their statements some assumption respecting the theory of apportionment, that is to say, respecting the principles ac-

according to which the duty of payment should be assigned to citizens. The controversies which at different times in the past have been carried on by students of taxation have centred about the rules of apportionment and of assessment. In case the controversy resulted in the acceptance of the idea urged by the theorists, it came to be a part of the established system of taxation, and for this reason it is possible to trace every qualifying attribute of the legal definition of a tax back to some controversy which has marked an epoch in the development of political liberty and property rights. Current controversies are not less significant. Two advantages, therefore, may be expected from a study of the definitions which theorists have from time to time presented. Such a study will, in the first place, impress the fact that the idea of taxation has passed through a development corresponding to the development of government itself, and it will, in the second place, lead to an appreciation of the fact that current controversies pertain to undeveloped or unsettled rights. The definitions which we are now about to consider will bear upon the fundamental principles entertained respecting the nature of society, the character of government, and the rights of citizens.

It would carry us too far from our purpose to apply the foregoing suggestions for study to all the definitions of a tax which have from time to time been presented. Confining our analysis to comparatively modern times, there are three conceptions of a tax that may with advantage claim attention. These are:

First. That a tax is a price paid for a service rendered.

Second. That a tax is a payment in proportion to benefits received.

Third. That a tax is a contribution of citizens to a common end.

(1) *The Purchase Theory of a Tax.*—The most general of the theoretic definitions of a tax is the one which conceives of a tax as a payment to the government for service rendered, and a payment equal to the cost of the service*. This conception is not open to serious criticism so long as the question of payment is regarded as lying between the State

* In the foregoing book the idea that a price is a tax was refused recognition, we now refuse to recognise the idea that a tax is a price.

and the taxpayers as a body, it is not satisfactory, however, when one holds in mind a general payment and a specific service rendered to him who makes the payment. The idea of purchase and sale as between the citizen and the State cannot be entertained without leading to untenable conclusions respecting the nature of the State, and, also, respecting the relations that exist between citizens and the State or between various classes of citizens. It implies, for example, that the State is something separate from the body of citizens, and does not fit itself easily to the conception that the State is the body of the people organized for governmental purposes. It implies, in the second place, that the citizen is at liberty to refuse the services offered by the government, and by refusing is able to escape the necessity of making payments. It implies, in the third place, that the relative duty of citizens to make payment for the support of government is in proportion to the expense which they occasion. All of these implications, for reasons that were suggested when the functions of government were under consideration, or which will be made clear when the theory of apportionment of taxes shall claim attention, must be regarded as unsound, and on this account the purchase theory of a tax abandoned.

(2) *The Benefit Theory of a Tax*—The second theoretical definition of a tax suggested above is that a tax is a payment by citizens to the State on account of and in proportion to the benefit received. This leads to what is commonly called the benefit theory of taxation. It is also termed the insurance theory or the *quid pro quo* theory of taxation; but however characterized the underlying thought is the same. The idea embodied in this theory of a tax is that, inasmuch as individuals receive benefits from the State, a payment should be made on account of and in proportion to those benefits. Like the purchase theory of taxation, it rests upon the individualistic conception of society. The two definitions are coloured by the same idea, the chief difference being that the one regards a tax from the point of view of cost to the State, the other from the point of view of advantage to the citizen. All of the considerations, therefore, which were urged against the conception that a tax is a payment to cover the cost of a service rendered applies with equal force to the idea that a tax is the equivalent of a benefit received.

It may be stated further that they who accept the benefit theory of taxation are thereby committed to the restrictive theory of government which prevailed in the early portion of the present century. Were the functions of government rightly restricted to the protection of life and property there would be some reason in saying that payment to the State should be equal to all citizens so far as expenditures for the protection of life are concerned, and in proportion to property so far as the activities of the State are devoted to the protection of property. The modern State, however, assumes duties far beyond the primitive functions of protection to life and property. Government is subject to a development *pari passu* with the development of society itself. If the analysis presented in connection with the Theory of Public Expenditures be accepted as correct, expenditures incident to the protective functions of the State, as compared with those that arise in connection with the developmental functions, tend to become less as civilization advances. While, therefore, the *quid pro quo* theory of taxation may have served fairly well under conceptions of governmental activity held in the early part of this century, it must be regarded at present as somewhat antiquated.

That phase of the benefit theory which has exerted the greatest influence upon the literature of taxation is the one which regards a tax as an insurance premium. Montesquieu, for example, says that "the public revenues are a portion which each subject gives of his property in order to secure and enjoy the remainder," and many writers there are who make this definition the basis of their analysis. Thiers states baldly that a tax is an insurance premium. This method of presentation suggests yet another criticism. Not only does it entertain an erroneous idea of the nature of government, and rest upon an inadequate conception of the functions of the State: it presents also a false idea of property and of proprietary rights. It is logical for Thiers, who believes all property to be the result of individual effort, and who asserts that the defence of private property is found in the fact of individual production, to conceive of a government as a great insurance company, accepting from citizens an annual premium as a guarantee against loss by theft or dishonest treatment. According to this idea the annual payment would not

necessarily be in proportion to the amount of property, which has been the commonly accepted idea of apportionment, but in proportion to the risk which the nature of the property entails. It is not necessary, however, to discuss at length the insurance theory of taxation, inasmuch as the defence of property upon which it rests has been for the most part abandoned. Few writers at the present time would care to assert that property is wholly an individual product, and still fewer there are who would care to deny that social utility is at once the basis and the defence of individual ownership. With such an idea the insurance theory of taxation is wholly at variance.

The above considerations respecting the purchase theory and the benefit theory of taxation are fundamental. They pertain to the nature of the State, to the relationship between citizens, to the character of government, and to the basis of property. They do not bring to notice the practical difficulties which would arise were it attempted to determine the cost of specific services or to measure the relative benefits of government to citizens. The administrative criticisms upon these theories of taxation will claim attention when the theory of apportionment in harmony with them is submitted for discussion. It is desired for the present to hold our analysis strictly to fundamental ideas.

(3) *The Contributory Theory of a Tax*—The third definition which presents itself in this connection conceives of a tax as a contribution from citizens for the support of the State. Several ideas are implied by the use of the word contribution. In the first place a contribution implies solidarity of social interest, or, to put this thought in another way, it implies that all the functions undertaken by the State are such as minister to common wants, and in large measure to wants which cannot be segregated or specialized to individuals or to classes. A sense of organic unity and of interdependence, and a consciousness of common rights and common duties, go along with the idea of contribution. The social concept with which this idea is in harmony does not permit of a separation between the State and the individual, as is the case with the social theories which conclude that a tax covers the cost of specific service, or that it is a payment for benefits received. The contributory theory of a tax concedes rather that the individual is a part of the

State and that he realizes his individuality, in some degree at least, because the State exists. All of these conclusions, as well as others familiar to modern political philosophy that logically follow from this general point of view, are bound up in the assumption that a tax is a contribution from the citizen to the support of the State, and not a price paid by him for specific service rendered or a compensation allowed by him for benefits received. This theory of a tax rests upon that phase of Greek philosophy which asserts that society is organic in structure.

It may further be added that this word contribution, when used to characterize the non-commercial payments from a citizen to the State, implies certain established relations between citizens who together make up the State. Since government is the agency of the whole people, and is established for the purpose of rendering a common service, it follows that a payment from a citizen to its support must be in proportion to some accepted rule of equity and justice, and it consequently lies in the contributory theory of a tax to assert that this payment should be made in proportion to the respective abilities of citizens to pay.

Conclusions—The results of the foregoing analysis, not alone in this chapter, but in the previous chapters as well, may be summarized in the four following statements.

First From the point of view of the State a tax is a source of derivative revenue.

Second From the point of view of the citizen a tax is a coerced payment.

Third From the point of view of administration a tax is a demand for money by the State in conformity to established legal rules.

Fourth From the point of view of theory a tax is a contribution from individuals for common expenditure.

50 Analysis of the Taxing Power—It was the purpose of the foregoing analysis to discover the true nature of a tax, and to arrive at a definition of use to the practical financier, because it fits into the legal conditions and social structure of the modern State. It is the intent of the present paragraph, which is devoted to a consideration of the residence and employment of the taxing power, to carry this general inquiry yet a step further.

(1) *Character of the Power.*—By the phrase taxing power is to be understood the legal right which a government enjoys of determining the amount which each citizen shall pay for the support of the State, and of forcibly collecting that amount if necessary. It is a sovereign power, and is so recognised, whether exercised by a monarch or by a government resting on popular suffrage. This must be the case since the payment in question is a coerced payment. Private property is taken for public ends, and none but a sovereign could consistently exercise such an unusual power.

It is not enough, however, to know that the taxing power is sovereign in character and that its exercise is the exercise of sovereign authority, it is equally necessary to learn with which of the three great departments of government—the executive, the legislative, or the judicial—this power resides. If the above question be confined to those peoples whose political ideas are coloured by the development of popular government, the answer is a very simple one. A tax must always be promulgated in the form of a law, and a law comes into existence only as the exercise of legislative authority. From our knowledge of the constitutional history of England we are acquainted with the struggle of the English people against the arbitrary exercise of the power of taxation, and from our study of rules and methods of budgets we have come to appreciate how firmly is this principle established. So important is it conceived that the taxing power shall reside in the legislative body that the legislative body itself is enjoined from delegating that power, either to the court or a corporate body of any sort, nor is it possible for a court to assume the exercise of this power; nor can the legislative body itself diminish by one iota its authority over the question of taxation, it being a fundamental principle of constitutional law that each legislature should hand down to the legislature which succeeds it all the rights, powers, and privileges which it received from the preceding legislature. Without further comment, therefore, it may be stated that whenever one reasons about the power to levy and collect taxes he is dealing with a sovereign power and with a power which is legislative in character.

Although the power to tax is a sovereign power, it is not necessarily superior to regulation and control. Especially is

this true in the United States, where the courts are given the authority to pronounce upon the constitutionality of legislative acts. This does not mean that the court is in any sense a law-making body, its chief social function being rather to preserve harmony in the development of legal principles and to maintain symmetry in the body of legislative enactments. There is nothing inconsistent in the statement that the taxing power is sovereign in character and to add, at the same time, that its exercise must conform to established rules.

These rules respecting the employment of the taxing power are suggested by the two following questions:

First. To what specific grant of sovereign power may the exercise of the taxing power be credited?

Second. What are the specific limitations to the exercise of the taxing power?

(2) *Grants bestowing the Power*—The meaning of the first of the above questions is that, although the general grant to tax resides in sovereignty, and, indeed, is essential in order that the State may maintain its dignity and perform effectively the functions assigned to it, still every specific exercise of that power must be referred to some specific grant, or to some general principle established as the result of a past controversy. Confining our analysis to the situation as it exists in the United States, the authority to levy and collect taxes, if it exist at all, must be found either in the Constitution of the Federal State, in the Constitution of a given State, in the charter of a municipality, or in the general laws passed by State legislatures conferring the exercise of the taxing power on the minor civil divisions. Each of these grades of government must have its legislative body, and from the above it appears that fundamental law prescribes the character of the taxing power consigned to each grade of government, and the extent to which and the conditions under which it may be exercised. This fact has a very practical bearing, for it shows that if harmony in methods of taxation is ever to be realized in this country the basis of that harmony must be laid in fundamental law or in inter-governmental agreement.

Another service is rendered by a study of the specific grants for the exercise of the taxing power. The simple rule of law respecting the employment of this power is that

it can never be employed except for the purpose of procuring revenue. The principle to which this rule gives expression is bound up in the very nature of a tax. When "the power which only exists for the purpose of procuring revenue for the needs of government," says Judge Cooley, "is used for some wholly different purpose, and no revenue is expected or desired from the employment, it is misused, and the misuse is usurpation"*. Proceeding from this principle of law many writers have urged the conclusion that the protective tariff, for example, is without legal authority. This would doubtless be true if the taxing power were the only power granted to the State. A duty imposed on the importation of goods which is prohibitory, and which on that account can give no revenue whatever, is not a legitimate exercise of the taxing power, this, however, is quite different from the conclusion that a system of protective duties is without legal warrant.

• Two remarks may be made upon this point. In the first place, it should be noted that while the taxing power is granted for the purpose of raising revenue, the legislature is not prohibited from employing it in such a way as to procure incidental benefits; that is to say, given the necessity for revenue, the legislature is in duty bound to choose the method the least detrimental to the public, and is at liberty to employ a method which may bring with it incidental advantages. Thus, while the prohibitory duty based on the taxing power would be illegal, a duty on imports which has for its chief purpose the securing of revenue, and which is incidentally protective, would be judged no abuse of that power. This may, perhaps, be a dangerous doctrine, but it is the position assumed by the courts upon this question.

There is yet another way in which this matter may be presented. A distinction must be made between the employment of the taxing power and the employment of taxing machinery. Thus taxes may be levied, and constitutionally justified, without any reference whatever to the power granted to the State to raise revenue. A protective duty, or, indeed, a prohibitive duty, may be referred to some other grant of power than that of taxation. It may, for

* *Principles that should Govern in the Framing of Tax Laws*. An address by Judge Thomas M. Cooley before the American Social Science Association, April 22, 1878.

example, be referred to the power of regulating commerce, and in reality this is the basis on which the whole protective system as practised in the United States rests. Or, again, a tax on hack-drivers, or bootblacks, or newsboys, a special license imposed on peddlers, auctioneers, etc., is not justified as a simple exercise of the taxing power. The purpose of these impositions is police regulation, and not revenue, and such an employment of taxing machinery must find its justification in the police power; it cannot rest upon the taxing power. The distinction here drawn may be seen yet more clearly should it be applied to the levy and collection of special licenses for the manufacture and sale of liquors.

The rule of constitutionality, then, is quite plain. The taxing power is a special power granted to raise revenue, but the taxing machinery, which is something quite different, may be set in motion on the authority of various powers for various purposes.

(3) *Limitations upon the Power*—The second of the questions presented above inquires what specific limitations upon the exercise of the taxing power are made by fundamental law. There are five points which present themselves in making reply to this question.

(a) Such limitations as exist pertain to the method of taxing, and do not inhere in the nature of the power to tax. There is no limit to the exercise of the power when properly applied. This principle seems to lie in the nature of sovereignty, and to be essential for the preservation of the permanency of a government intrusted with jurisdiction over war and peace, or which, indeed, in the exercise of its functions, is liable to be called upon as the final arbitrator respecting any public question.

This at least is the position assumed by the Supreme Court of the United States as declared in the familiar case of *McCulloch v. Maryland*. In rendering the decision in this case Mr. Justice Marshall said, "The power to tax is the power to destroy." And again, "If the right to tax exist, it is a right which in its nature acknowledges no limits. It may be carried to any extent within the jurisdiction of the State or corporation which imposes it which the will of such State or corporation prescribes." It is true that the point in this case pertained to the right of the State of

Maryland to tax the notes of the Federal bank, and that the object of Maryland in imposing such a tax was to drive these notes out of the State so as to make room for the circulation of the notes of State banks. Thus the point at issue did not pertain to the use of the taxing power for raising revenue, but to the use of the taxing machinery for a purpose other than that of securing revenue. It has, however, been generally accepted that the principle laid down above is of universal application, and it has been followed quite closely in the subsequent development of American law.

In applying the rule that the power to tax "acknowledges no limits" it is necessary to distinguish between its exercise by a government recognised as sovereign, even though it be within a restricted jurisdiction, and a government which is the representative of or the agent of a sovereign government. A county, a township, or a school district, for example, is, strictly speaking, no government at all, but an administrative unit acting for a government for certain specified ends; and there is no inconsistency in limiting these minor civil divisions in their exercise of the power of taxation. This, however, according to the theory of American law, must find expression in the fundamental law of the State itself.

(b) The general rule respecting the employment of the taxing power is that it should be used only to procure revenue for public purposes. As has been already pointed out, this follows logically from the fact that the power of taxation is a sovereign power, and the limitation imposed on government is a limitation bound up in the nature of the tax itself. It will be remembered that in considering the legal definition of a tax this point was dwelt upon at some length, and it was shown that the remedy against the abuse of the taxing power was political and not legal in character. In the main such a statement is correct, but it should not be pressed so far as to lead to the conclusion that the courts, in this country at least, are not at liberty to express themselves respecting the purpose for which a tax is levied. The first decision respecting what is or is not a public service lies undoubtedly with the legislature, and it may be added that the existence of a law duly sanctioned by the legislative body is accepted as presumptive evidence that the purpose for which a tax is levied is a public purpose. The evidence, however, is presumptive

and not final, and in extreme cases the question may be presented to a court for adjudication. This whole question is a very difficult one and has given rise to a long line of cases. In general the courts refuse to lay down any definite rule, but insist on deciding every case which comes before them upon its own merits, having regard, of course, to previous decisions in analogous cases. The following quotation taken from a decision in one of these cases may serve to illustrate the general point of view. "A tax must be considered valid unless it is for a purpose for which the community has no interest, when it is apparent that the burden imposed is for the benefit of others and where it will be pronounced so at first blush." A case presented itself in Maine where the council of a town imposed a tax the proceeds of which were to be again distributed among the people of the town, a case which was promptly decided as illegal.

Taxes, also, the proceeds of which are paid as a bonus to some manufacturing company as an inducement to locate in one place rather than another would seem to lie outside an appropriate exercise of the taxing power, but in making statements of this sort respecting American law one should remember that he is dealing with a large number of independent sovereignties. He should also recognise that the legality of a tax, so far as it is affected by the purpose for which it is levied, depends upon the accepted ideas respecting the proper functions of government, and on this account may vary from time to time. The courts are obliged to take into consideration the new ideals entertained by the people as well as the precedents from previous decisions. The limitation in question, therefore, is upon analysis found to be nothing more than a guarantee that the taxing power shall not be employed for any purpose except one of common interest, and to which the body of the people has fully and finally committed itself, and the service rendered by courts in assuming to check the action of legislative bodies in extreme cases is, in reality, nothing more than the protection of the public against its own enthusiasms. It was never intended that the legal principle which asserts that the taxing power should be employed only to procure revenue for public purposes should act as an obstacle to changes in the social and industrial structure of society.

(c) The taxing power is further limited by the claim that its exercise must pertain to the grade of government by which or for which it is put into operation. This principle has no very definite meaning except it be applied to some particular State. In the United States, as has been already remarked, the governmental functions are divided between the Federal State, the commonwealths, the municipalities, and the minor civil divisions. To each of these is assigned a definite set of functions, and the idea underlying the limitation of the exercise of the taxing power above stated is that each grade of government has the right to exercise the taxing power in such form and to such extent as may be necessary for the satisfactory performance of public functions assigned. The reverse of this statement is also true, that each grade of government should be protected in the exercise of its taxing power against the encroachments of the other grades of government. The practical application of this principle has not, as yet, been very fully developed, but, as will be made clear when the existing system of local taxation in the United States is subjected to critical analysis, it is a principle upon which continually increasing reliance must be placed. Harmony and symmetry in the taxing policy considered as a whole are essential to a sound fiscal system, but there is no possibility of attaining such harmony and symmetry until the respective rights of the various grades of government in matters of taxation are more perfectly worked out.

(d) The taxing power cannot be exercised, in the fourth place, so as to encroach upon the established rights and privileges of citizens. The chief effect of this principle is to restrain the commonwealths from imposing burdens or restrictions upon the citizens of neighbouring States which they do not impose upon their own citizens. The depository of this right is the Federal Constitution, and it is to the Federal courts that any State must look for protection against the improper use of the taxing power by another State. Its necessity and its sanction is the fact that it is essential to the existence of the national government. Thus the Federal Constitution guarantees the citizens of each State the privileges and amenities of the citizens of every other State. No discrimination can be made in the framing of tax laws unless it can be clearly shown that, as a result of a formal dis-

crimination, greater equity is secured as between those who are called upon to make payment than would otherwise be the case. A discriminating license tax, for example, upon the citizens of other States, or of other localities within the State, is not permitted, for these are assumed to have paid taxes where they live; special taxes upon peddlers, on the other hand, not living in the State are regarded as lawful, since otherwise these citizens might be free from the payment of any tax whatever. The purpose of the principle under consideration is to maintain equality of opportunity without regard to residence or occupation, and any apparent discrimination necessary to the attainment of this end is not conceived as contravening the principle enunciated. The limitation upon the exercise of the taxing power here laid down is coming to be an increasingly important one in view of the development of interstate commerce. The truth is that commercial relations no longer have regard to political jurisdiction, and on this account the framing of a satisfactory system of local taxation is exceedingly difficult. This legal principle, like the one just referred to, will be held constantly in mind when the existing system is subjected to critical and, we trust, constructive examination.

* (c) It is further stated as a limitation of the taxing power that it cannot be exercised so as to impair the obligation of contracts. This is simply a special application of the general law as found in the Constitution of the Federal Government and of the several States. An exhaustive discussion of this principle will be found in all the text-books upon the law of taxation. It is of too technical a character to receive consideration in this treatise, and on that account we must rest satisfied with the mere statement of the principle itself.

51. Concerning the Duty to Pay Taxes.—The duty to pay taxes is one that is owed by the citizen to his sovereign. This is the fiscal expression of a fundamental political relation, and the first conclusion to be drawn from it is that no sovereign is at liberty to look to a foreign people for any portion of orderly revenue. The purpose of charging the cost of the home government upon the subjects of a foreign State is not only immoral in itself, but it is contrary to the spirit of international comity, which at the present is about all the "cosmopolitan State" has to rest upon. Moreover, it is bad

international policy, for it overlooks the fact that good government in a neighbouring State is one of the essential conditions for the enjoyment of good government at cheap cost in the home State, a fact which leads to the conclusion that the money which a foreigner can justly be called upon to pay for the support of government is most judiciously expended when paid for the support of an efficient administration in his own State. Yet a further consideration may be urged against the purpose of attempting to throw the burden of the home government upon the subjects of a foreign State. Such a purpose would undoubtedly lead to retaliatory laws. The evils and bitterness of feeling which would be sure to arise from such a state of affairs far outweigh any fiscal advantage to either party, and, in case the laws of each nation are equally effective, it is clear that neither party would be permanently benefited. We may, therefore, conclude, without discussing the conditions under which it is possible for a government to obtain revenue from the subjects of a foreign State, that the duty to pay taxes exists solely between a citizen and the State to which he owes allegiance, and that the endeavour to collect revenue from a foreign country not only rests upon an immoral purpose, but it is unsound from the point of view of international comity and incapable of success as a fiscal policy.

The fact that the financier must look to persons and property within the jurisdiction of the government whose affairs he administers presents one of the most difficult of the formal questions that arise in connection with the general subject of taxation. Were it true that all subjects lived within the jurisdiction of the government which grants them citizenship, and that all of the commercial relations from which men draw an income were limited to the jurisdiction of a single sovereignty, there would be no reason, so far as residence or the situation of property is concerned, why the theory of taxation which levies payments upon persons and property could not be easily realized. But such is not the fact. Citizens pass freely from one jurisdiction to another, and it cannot be assumed that the income which they enjoy accrues from a business or from property lying wholly within the jurisdiction of a single sovereignty. The difficulties to which this situation has given rise are, first, the evasion of a duty to pay

taxes by virtue of a foreign residence, and, second, the duplication in the levy and assessment of taxes by virtue of the fact that a citizen may be called upon to make payment where he lives, while his property is assessed for payment where his property exists. It will add to our appreciation of the conditions under which a successful revenue system must be administered if we consider for a moment these two classes of difficulties.

(1) *Difficulties of Administration due to Foreign Residence* —

The simpler of these questions pertains to the various relations existing between the subject and the sovereign on account of residence. These relations are three in number and are as follows.

(a) A citizen may have his domicile within the State to which he owes allegiance and draw his income from a property or from a business within the same jurisdiction. This is the simplest of all relations and in theory at least presents no difficulties. Under such circumstances a citizen must pay whatever personal tax is levied, he must also pay all taxes imposed upon his property. There is here no possibility of evasion or duplication, except of course it be traceable to the bad intent of the citizen in declaring his property, or to the negligence or ignorance of officers in administering the laws. Any evasion or duplication under the conditions assumed cannot be charged to the system.

(b) The subject of the State may, in the second place, live outside the jurisdiction of the State to which he owes allegiance. A citizen of the United States, for example, may live abroad, or an individual who has property in one State may be a citizen of a neighbouring State. In this case the duty to pay taxes according to the established rule depends upon the kind of property from which the citizen in question derives an income. The rule is that personal property follows the domicile of the owner, and no tax can be imposed by the home government so long as the citizen maintains a foreign residence. This, however, is the formal statement of a general practice. Quite a number of modifications have been introduced in order to prevent the evasion of the duty of paying taxes by the judicious selection of residence. If the property from which a citizen secures an income is real rather than personal, it will be taxed at its situs regardless of the residence

of its proprietor. If the income arises on account of a business that has a legal situs, as, for example, a corporation, the State levies its tax directly upon the corporation. The form which the corporation tax assumes is of no importance. It may be upon the capital stock outstanding, it may be upon gross earnings, or it may be in the form of a franchise tax; in any case the theory is that he who has invested his money in a corporation is taxed in the tax to the corporation. It may be that the business from which a foreign resident secures an income exists within the jurisdiction of the State in the person of a trustee or an agent, in which case the tax upon the business is left against the legal representative of the proprietor. Or, finally, it may be that the income enjoyed by the foreign resident accrues to him as interest from investments in government bonds, in which case the tax, or an equivalent for the tax, was taken at the time the government sold its bonds, since, on account of the clause which exempts such obligations from tax, the price paid was higher than the commercial capitalization of the income. It thus appears that, in theory at least, a citizen cannot evade the duty to pay a tax on account of the fact that he resides either temporarily or permanently in a foreign country.

(c) The third relation which the subject may hold to the sovereign in the matter of taxation presents itself when the subject of a foreign State, living outside the jurisdiction of the home government, may have availed himself of some of the public agencies of the home government. For example, a foreign subject living abroad may be a party to a suit in the courts of the home government. In this case he is charged the fees and expenses which are properly regarded as a form of public revenue. Or the subject of a foreign government living abroad may fall heir to property which makes part of the wealth of the home State. Under such circumstances it is not at all uncommon for the government to impose a special inheritance tax upon property passing out of the jurisdiction of the State. The defence of such a tax is that, by the transfer of property to the subject of a foreign State living abroad, the taxable basis of property is reduced, and the orderly income of the State is thereby decreased. In order to make good this loss the government feels justified in imposing a tax upon the legacy equal to the

capitalization at the current rate of interest of the annual tax-proceeds of the property.

The relationships here portrayed might be increased in number by assuming the reverse conditions of the different cases. But it is not necessary to present in detail such cases. A fundamental principle is involved, namely, the principle of international comity. For all practical purposes it may be assumed that the ordinary governmental services rendered by one State to the citizens of another for which no direct payment is demanded will be balanced by analogous services rendered by a foreign State to the citizens of the home State. In so far as property is the object of taxation rather than persons it may be said that the citizen residing abroad who receives benefits from the foreign State for which he does not make explicit payment, has placed the property from which he derives an income at the disposal for taxing purposes of the home government in order that the foreign citizen may receive corresponding services from his own government. Moreover, the personal and property taxes do not exhaust the list of possible taxes. Besides these there exist those taxes which find their way into the price of consumable commodities, and these are paid by him who consumes them, regardless of his domicile or the situs of his property. It thus appears that the duty to pay taxes is universal, that it is a duty imposed upon him who receives the benefits of government, but that in order to secure this payment it is not always necessary to follow the individual from whom finally the payment comes. Certain modern governments do attempt to tax foreign subjects residing within their jurisdiction, but such attempts can only be successful so long as they are followed by insignificant results. Indeed, the theory of securing payment immediately from individuals is one that, in the complex condition of modern society, and in view of the free migration among modern peoples, is impossible of realization.

(2) *Difficulties of Administration due to Diffusion of Business Interests.*—The other side of this difficulty presents itself when one considers the fact that commercial relations extend beyond the jurisdiction of the taxing body. This is one of the incidental results of the development of a world's market, of the rise of corporate enterprises, and of the tendency to-

ward the establishment of great industries. An illustration will make this matter plain, which, for purpose of explicit statement, we confine to the political organization of the United States. A railway in this country may extend through several States, and even within the boundaries of a single State it may come under the fiscal jurisdiction of a considerable number of minor civil divisions. Now it is clear that much confusion may arise on this account, and that evasion of payment as well as duplication of assessment may result from such lack of organization.

An insurance company also, to cite another illustration, may have its local residence within the jurisdiction of one State, and it will probably write policies in many neighbouring States. In this case, as in the case of interstate commerce, the income is due to transactions which the corporation has with citizens of a foreign jurisdiction. Should, now, the home jurisdiction impose a tax upon the franchise to its full value, and the neighbouring States impose a tax upon the earnings of the corporation arising from business relations with their citizens, it is clear that the corporation in question would be subject to double taxation. Without inquiring as to whether this is just or not it is a sufficient criticism that in this manner the revenue system as a whole is seriously embarrassed.

Yet another illustration of confusion and possible duplication in the application of taxing laws under the conditions described is found in the debit and credit relations existing between subjects of the several States. A citizen of one State may, for example, loan money to a citizen of another State, and secure the loan by taking a mortgage upon property. If, now, he is taxed upon the mortgage as personal property by the government to which he owes allegiance on account of residence, and the borrower of the money is taxed upon the value of the land mortgaged without deduction for the debt, it is clear that the property, that is to say, the land mortgaged, is taxed at a figure in excess of its true valuation.

It is not designed at this time to discuss the question of corporation taxes or of duplicate taxation arising on account of mortgages. Sufficient has been said to make clear the fact that modern industrial conditions have outgrown the old revenue system which rested upon the assumption that both

persons and property are confined to the jurisdiction of the government to which they owe the duty of payment. Our general conclusion, however, will not be modified by the consideration of these questions. The duty to pay taxes is one that the citizen owes to his own government, but it is not necessary for the government, in securing the fulfilment of this duty, to follow the citizen in residence or the property in its situs. It is likely that the future revenue laws will consider the commercial activity of property rather than its situs as the basis of payment.

52. Principles of Tax Exemption — Closely connected with the question of the duty to pay taxes is the question of tax exemptions. There is one fact respecting this question which may be stated without fear of contradiction: it does not lie within the idea of constitutional government that any citizen should be exempt from the duty of contributing to the support of the State on personal or class considerations. In this regard the conditions which existed in France previous to the French Revolution, when all taxes were imposed upon the third estate, the clergy and nobility being exempt, have entirely passed away. Such exemptions as exist at the present time must rest on grounds of general expediency, and be capable of expression in some rule of general application. No question respecting taxation has been the subject of fiercer controversy than this one of exemptions, a fact which in itself shows how clearly public opinion recognises that the duty to support the State is universal, and that government is not at liberty to show favours in the levy of taxes. Tax exemption must apply to some condition or quality of property, and not to individuals or classes.

Looking at matters as they exist at the present time, it appears that tax exemptions rest upon one of three considerations. A mere statement of these considerations will probably secure for them general approval. They are as follows:

First The State should not tax itself. It has no reason to tax itself, nor could such a procedure influence in any way its real financial standing. The apparent income might, it is true, be increased by this means, but the real income would in no manner be affected. All property belonging to the State, therefore, as well as all instruments or agencies em-

played exclusively by the State in the performance of its delegated functions, should be exempt from taxation.

The above rule does not require that salaries of public officers should be excluded from the rolls of an income tax. Thus the Federal income tax of 1861, as also the income tax of 1894, recognised no difference between the salaries of Federal officers and the earnings of the professional man or the profits of the business man as a basis for imposing the tax; and the laws referred to followed in this regard the general practice of European states. The reason for making a distinction between public property and the salaries of public officials lies wholly upon the surface. The property is for the use of the public and discharges its duty to the public by being used for a public purpose; the salary of an official, on the other hand, is for his private expenditure as a citizen. The fact that a salary is compensation for a public service does not change its private character. Like the fee of a doctor or lawyer, or the profits of a merchant or manufacturer, it constitutes a fund for domestic expenditure.

A further consideration in support of this conclusion may be added besides the one which arises from an analysis of the nature of the income. Assuming the salaries of public officials and the incomes of citizens engaged in private pursuits to have been properly adjusted prior to the tax, the exemption of officials from the rolls of an income tax would tend to disturb established relation between the various classes of income. It would be equivalent to a rise in the salaries of public officials. It is of course true that were the tax in question permanent, so as to be rightly considered a fixed charge on income, an exemption of public officials might ultimately result in a relative decrease of public salaries, that is to say, the tax would be borne by this class of citizens, although their earnings would not be listed among taxable incomes. As the income tax is used by modern States, however, it cannot become a permanent charge at a fixed rate, and on this account it has come to be the general practice of nations to refuse to exempt the salaries of paid officials from taxation.

A curious case arises in the United States in connection with the taxation of salaries of public officials on account of the peculiar relation which exists between the Federal Govern-

ment and the State governments. It is very properly assumed by the courts that neither grade of government should be jeopardized by any act of the other. Each is sovereign within its own jurisdiction, and the integrity of the State as constituted demands the continued exercise by each grade of government of all powers and privileges with which it has been intrusted. Reasoning from this premise, it has been held that the salaries of officials paid by one grade of government cannot be taxed by the other, since, in view of the fact that "the power to tax is the power to destroy," this would give to either government the power to destroy the agencies by which the other is alone capable of performing its public duties or of continuing its active existence. With this exception, however, salaries of public officers are subject to taxation.

The query may arise, in case a government is engaged in an industry which competes with a private industry, if it would be just to a private industry to impose a tax upon it, while the public industry is exempt from taxation. Such an exemption would without doubt be unjust were the State to administer the industry in all respects as it would be administered by the private corporation. But, as has already been pointed out, it is impossible for the State to ignore the fact that it is the depository of the sovereign power, and that it stands for the common interest of all the people, even when it undertakes the management and the control of the industry. The competing industry under private management, therefore, need not fear the competition of the State, even though public capital be exempt from taxation, provided only that the principles laid down for the conduct of a public business be conformed to. There is no necessity, therefore, for the purpose of securing equity between the State and its competitors in a business that the former should tax its own instruments of production.

It is common for States to exempt from taxation the bonds which they issue, the exemption being made a part of the contract between themselves and the public creditors. This provision has been subject to much criticism. Its defence, however, lies in the fact that a bond which guarantees perpetual exemption from taxation will bear a much higher price than a bond subject to the uncertainties of subsequent taxa-

tion. It is usually the case when bonds are issued that the government is in pressing need of funds, and on this account it is deemed wise to draw the contract in such a manner that the bonds will sell for the highest possible price

Second The second consideration asserts that property which is believed to assist the State in the fulfilment of its public functions should be exempt from taxation. There is here introduced for the first time a very important consideration. In matters of taxation the financier is obliged to recognise the actual condition of public opinion. This opinion may rest upon a satisfactory basis or it may not. The fact of its existence is for some purposes sufficient to control the judgment of the financier; for it must be remembered that he desires, next to the attainment of a system of equitable taxes, a system that will work smoothly and efficiently, and on this account the deep-seated prejudices for or against any particular suggestion will ever remain an important consideration in the drafting of tax laws.

Applying this principle to the case in hand, it follows that church property, property of educational institutions and in general of all corporations or associations which are engaged in religious, educational, or philanthropic enterprises, should be exempt from taxation. There is, however, this limitation, which is manifestly just, that the exemption attaches only to such property as is strictly used for the purposes named. In case of a church society, for example, its house of worship would be exempt from taxation, but if the society in its corporate capacity own productive property from which it derives a revenue, such property would be subject to taxation

Third The State should not tax capital regarded as essential for extending the source of future income. It will be remembered by referring to the Introductory Chapter of this treatise that one of the fiscal axioms laid down asserts that a sound revenue system will not impair the patrimony of the State. This third class of exemptions is but an application of this general principle. The duty of the financier is not limited to the getting of revenue, but he is obliged to get revenue in such a manner that the source from which it is derived shall never be exhausted. He must hold in mind the needs of the future as well as of the present, and

is therefore debarred from employing the taxing power in such a manner as to dry up the springs of present revenue or to hinder the development of an enlarged supply

One of the most common facts in connection with modern systems of taxation is the exemption of incomes and property below a certain amount, and many financiers justify this exemption on social considerations. It is not right, they say, to call upon a citizen to contribute to the budget of the State until the necessary domestic budget has been provided for. Without admitting any man's right to live in the modern State without contributing to its support, a modified application of this principle may be defended on purely fiscal grounds. The surest source of public wealth is a lively hope and a healthy expectation on the part of the great body of citizens, and in so far as exemption of low incomes and small salaries from taxation induces to the conditions from which this hope springs such exemptions will tend to the expansion of a nation's wealth. If this be true the exemption of small incomes from direct taxation, as also of the property of those who relatively are poorly able to pay for the support of the State, must ultimately result in the development of a source of wealth from which the State may expect to derive an increased revenue.

Another application of this same principle is found in the exemption from taxation of mechanics' tools. These are not only the means of his livelihood, but they are the means by which he secures funds to pay his share for the support of the State. Their possession is an essential part of the ability of the workman to gain a livelihood, and for that reason are exempt from all ordinary liens and attachments. These two illustrations indicate the reason for this third class of exemptions. It is not conceived that the needs of a government can ever become so pressing as to warrant the levy of a tax that will depress the wealth of the nation or impair the ability of citizens to secure an income.

CHAPTER II.

CONCERNING THE PRINCIPLE OF APPORTIONMENT.

SPECIAL REASONS FOR EQUITABLE APPORTIONMENT.

ANALYSIS OF THE RULES OF APPORTIONMENT.

- (1) Apportionment and the Cost Theory of Taxation.
- (2) Apportionment and the Benefit Theory of Taxation.
- (3) Apportionment and the Contributory Theory of Taxation.

RESPECTING THE FUND FROM WHICH TAXES ARE PAID.

- (1) Characterization of Income.
- (2) Relation of Property to Income.

CHARACTERIZATION OF PROPORTIONAL AND PROGRESSIVE TAXATION.

ARGUMENTS FOR AND AGAINST PROGRESSIVE TAXATION

- (1) The So-called Socialistic Argument
- (2) Progressive Taxation and Equality of Sacrifice.
- (3) Progressive Taxation and Industrial Development.
- (4) Conclusion

THE question of apportionment of taxes leads to a consideration of the relative duty of citizens to pay for the support of the State. The student is not left entirely to speculation respecting this subject. As has been already pointed out, it lies in the nature of a tax, and of the political conditions in which taxation presents itself as an important public problem, that payments for support of the State should be equitable as between citizens. The principle of apportionment, therefore, according to which this duty is assigned, must recognise all those complex relationships which modern philosophy finds in the phrase political equity.

53. Special Reasons for Equitable Apportionment—No argument is needed to enforce the conviction that taxes should be apportioned on the basis of equity, but a few words may be added to render yet clearer the nature of this necessity. The power to tax is a sovereign power, and its exercise should be equitable for the same reason that every

act of government should conform to what is fair and just * Now that the personal sovereign is no longer a menace to the rights of the people, the importance of relative justice as between citizens is the strongest apology for popular government This demand for equity, therefore, finds its ultimate sanction in the structure of the State itself, and when used in connection with taxation it is merely an application to a specific case of a fundamental conception respecting popular government

It is possible, however, to discover a more commonplace reason for an equitable distribution of payments Taxes are frequently spoken of as burdens, and there is no objection to such a use of language, provided the phrase is employed in the same sense as when speaking of any of the necessary items of expenditure in the domestic budget If the payment of a coal bill or the quarter's rent be a burden, then is the payment of a tax a burden. Using the phrase in this sense it is clear that the payment of any definite amount, the various expectations from life due to a customary standard of living being for the moment dropped from view, is felt to be a burden in proportion to the size of the fund from which it is made. The burden of a payment is measured by what is left after the payment, rather than by the amount paid. It is the surplus over the necessary expenditures of life which minister to the developing, and therefore the most keenly sensitive, wants This is the explanation of the universal opinion that where fortunes vary equal payments would not be equitable as between citizens; and the commonplace argument for equity in matters of taxation, to which reference was made, rests upon the assumption that the relief to him who fails to pay his just share is not as great as the burden which this relief imposes on some other member of the community who on this account pays more Equity in the apportionment of taxes, therefore, reduces the burden for the support of the State to its minimum, just as a scientific adjustment of straps and buckles by which a knapsack is slung to a soldier's back makes the load carried as though it were light † It thus appears that a just system of taxation is equivalent to economy of social energy, from which it fol-

* The student of course recognises this as coming from Mill.

† A common simile of German writers.

lows that the principle according to which taxes are apportioned may have a very direct bearing upon the rate of social development

The above thought may be pressed yet a step further by showing more specifically how equity in the levy of taxes bears upon the development of a nation's industries. A payment of any sort works its way into industrial conduct through the incentives to industry resulting from the satisfaction which follows the payment in question. The labour which will be undertaken in the future depends in large measure upon the degree of satisfaction resulting from the labour of the past. This, tempered, perhaps, by the instinctive hopefulness of mankind, is the fundamental law of industrial conduct. Is it not, then, clear that an inequitable apportionment of taxes, which deprives him who pays too much of more satisfaction in the expenditure of his income than it adds to that of him who pays too little, results in weakening the aggregate of the motives to industrial activity? Thus the universal experience of nations, that one of the surest ways to encourage industry is to adjust the fiscal system to the demands of equity as between citizens, finds upon analysis a psychological basis.

There are, then, three reasons why equity should control apportionment. It is demanded by the accepted governmental principles of free states, it is essential to the economy of social energy; and it is important as a means of presenting motives to industry in the most effective manner.

54 Analysis of the Rules of Apportionment. — It is one thing to conclude that equity should give character to apportionment; it is quite another to discover an intelligent and at the same a workable rule for the attainment of this end. Some progress in this direction was made when considering the theorist's definition of a tax, since it was there shown that a tax could be considered neither as the price charged for public service nor as an equivalent paid for value received. On the other hand, it was concluded that a tax is a contribution to a common fund designed for a common end. Manifestly, the principle of apportionment adopted will ally itself to the accepted conception of a tax; and we might, therefore, in strict logic, proceed at once to inquire what theory of apportionment is bound up in the statement that

a tax is a contribution. This, however, would exclude certain considerations capable of throwing considerable light upon a difficult problem. It would also result in an opinion arrived at from theory alone, ignoring those practical considerations which so largely control in matters of finance, and which do not present themselves until one begins to trace the consequences that follow the application of the principles adopted.

(1) *Apportionment and the Cost Theory of Taxation*—A moment's consideration is adequate to show that the duty to pay for the support of the State cannot be assigned to citizens according to the cost to government of the service rendered. The fact that this cost cannot be specialized is of itself final against such a rule. Protection, for example, consists in creating and maintaining a condition of security in society, and its cost cannot be divided up and parcelled out. The law undertakes to arrest and punish every criminal, no matter what the cost may be, neither as an act of retribution nor to enable him who suffered the wrong to enjoy revenge, but because every miscarriage of the law tends to destroy the conditions under which life is secure. "The value of government to any man is proportioned to the completeness of the protection it extends to all men. If it undertook to protect only those who contribute to its cost, it would thereby breed lawlessness and invite anarchy" *.

The error underlying the rule that taxes should be apportioned to cost is further shown by applying it to the protection of property. All property is not of the same sort in that its protection does not occasion the same expenditure. More litigation, for example, arises respecting property that exists in the form of a patent privilege, a franchise, or any sort of a grant whatever, than is the case respecting property open for investment to all who possess free capital. The State could not, however, on this account impose heavier burdens upon it than upon ordinary property. A better illustration may be given. Security of property depends in large measure upon the enlightened self-interest and moral sense of the community in which it exists. Where the grade of intelligence is low the cost of protection is high; where the grade of

* Cooley, *Principles that should Govern in the Framing of Tax Laws*, p. 5.

intelligence is high the cost of protection is low, but, provided two such communities have intercourse with each other, it is of as much importance to the community where property is secure that property be protected in the community where it is exposed to danger, as that its own property should be guarded. Here, again, as in the case of protection to life and limb, the end of government is to maintain a condition of security, and it is easy to see that the protection of property on the borderland of attack is essential to the security of that which on account of its situation is relatively less exposed. The rule of apportioning taxes according to cost is not capable of realization.

Moreover, the theory on which it rests fails to harmonize with one's ideas of equity and justice as between different classes of property or property differently located. It is not fair that property which already carries a burden on account of the fact that from its nature or condition it is insecure should be imposed with unusual taxes, when its protection is essential to the security of all property in the community. To apply the principle of cost in the levy of taxes would be to call for heavy payments from the weak in order to render small the payments from the strong, and since the payment is a coerced and not a voluntary payment, such an assignment of the duty to support the State cannot be regarded as equitable employment of public authority.

No government, so far as the writer is aware, undertakes to apply strictly the rule of apportionment now under consideration. But there are many instances in which the principle of cost is permitted to shape in a very marked degree financial policy. Indeed, a survey of the taxing system of modern states offer some warrant for the generalization that according as a people has emerged from feudalism at a remote or recent date, so will be the extent to which taxes are apportioned on the basis of cost. In England at least, where feudalism was abandoned in the sixteenth century, very little is known of the specialization of public services, while German peoples, from whose administrative *régime* the influence of feudalism has not yet passed away, consciously recognise the rule that payment for the support of the State should be adjusted to cost. The classifications of service which permits the theory of specialization to be realized are

both interesting and instructive. The one here given is taken from the Austrian writer, von Hock. According to von Hock the services of the State are regarded as embraced under three classes, as follows

First Every one who acknowledges himself as a loyal subject of the government enjoys from the State protection of person, the care of the State for safety, and for the preservation of general order, for cleanliness, and freedom from disease, he enjoys also the dignity and sense of importance which comes with the strength and reputation of a nation, and avails himself also of the privilege of carrying on an industry, trade, or profession within the State which would not be possible except the State exist. These and other like services are personal and direct. They are rendered to rich and poor alike, and should on this account be made the basis of the personal tax.

Second Whoever has possessions in a State and invests his property in an industrial calling enjoys the protection of the State for his property and his industry, the courts enforce legitimate contracts and guard him against all fraudulent procedures, he enjoys the advance in the value of property that accrues on account of the growth of society; or, without further specification, reducing all these services to a common basis, each citizen enjoys a given income under the protection of the State and in part because the State exists. This class of services is made the basis of the income or property tax.

Third. In addition to the above there are a large number of special and peculiar services which the State renders to individuals. Public education, the building of highways, the transmission of news, the conferring of honours, the recording of mortgages, and the like, are illustrations of the services in question. Being special in their character, they should, according to the purchase theory of taxation, be made the basis of a special payment*.

Should one insist on proceeding from the *quid pro quo* theory of taxation he probably could not find a better classification of public services for that purpose; a good classification, however, does not set aside the errors in theory or the

* *Die öffentlichen Abgaben und Schulden*, pp 15, 16.

appear, yet this is what the benefit theory of taxation logically applied would lead to.

The theory of apportionment now claiming attention will be recognised as unsound if, in addition to noting its practical results, one observes that it calls for an estimate of what is beyond estimate or for which there is no comparative basis of estimate. Government is essential to civilized existence and there is, therefore, no basis for calculating the value of the services which it renders. "If government," says Judge Cooley, "were something to be taken up or dispensed with at the option of individuals, that method of estimation would take on a different appearance, but when the existence of a government in some form is confessedly something always to be assumed, it is clear that there can be no basis for an estimate of its value as compared with that condition of things in which there should be no government at all. It is true that if a theory valuable for practical application can be deduced from any imaginary state of things, there is no reason in the baselessness of the assumed facts to preclude our availing ourselves of it. The theory that government is founded in contract may answer a good purpose, though historically it is baseless. But so long as it is impossible to estimate the relative value of government to person and property, and impossible to collect taxes according to it if the estimate were practicable, it is manifest that any theory of taxation drawn from an impossible comparison of a state of society under settled government with an imaginary state of things when no government exists must be absolutely without practical value."^{*}

(3) *Apportionment and the Contributory Theory of Taxation*—It is hoped that the foregoing considerations have served to impress upon the reader the conception of solidarity in modern society, and of common interests which do not admit of segregation either as a cost to the government or a value to the citizen, for it is under the influence of this conception that the true theory of apportionment must be developed. A tax is a contribution from private funds to the public purse, and the principle according to which the government should determine for each the amount of

* Cooley, *Principles that should Govern in the Framing of Tax Laws*, p. 4.

his contribution is found in the expression that each citizen should pay for the support of the State in proportion to his ability as compared with the ability of others.

Should one ask why ability is accepted as the basis of apportionment, perhaps the most satisfactory reply would be that it approves itself to the moral sense of men in all cases where common expenditures are met by means of contributions. A church, for example, in which the sense of duty in the matter of payments is more highly developed than in any other voluntary association holds it as a common law of religious sentiment that the rich member should pay more for common ends than the poor member; and the measure of his greater payment is his ability, all things considered, to bear the payment. This is the New Testament doctrine of service, and its acceptance as a canon of taxation shows that the modern science of finance recognises one of the fundamental principles of Christian ethics. Not alone in the church is this rule of service recognised, but in all voluntary associations, whether temporary or permanent, it is admitted as a principle of action, provided only the association acknowledges a solidarity in the interests of its members*. It may, then, be asserted without further comment that the rule of apportionment which calls for the levy of taxes according to the ability of citizens to pay finds its sanction in the moral sense of the community, and this in all matters of social rights and social duties must be accepted as final.

The inquiry may perhaps be raised, in view of the fact that the contributory theory of a tax was not granted approval until comparatively recent times, whether modern peoples are influenced by finer conceptions of justice and equity than was the case in the past. This may possibly be true, but the acceptance of the principle that taxes should be levied according to ability, in place of the "cost" or the "benefit" theory of apportionment, does not prove it to be true, inasmuch as a consideration of the social and industrial conditions under which these abandoned theories were

* A club with annual fees does not commonly realize solidarity of interest. Should this however be the case in some particular instance, a club would still have no need to recognise ability of members in securing means for pecuniary support, since its members are all of the same class and consequently equal payment for club expenses becomes equitable payment as between club members.

held will show that they were capable at the time of securing substantial justice as between citizens.

Consider, for example, the rule upon which the colonial taxation of Massachusetts rested. "Every man's life," it was asserted, "is equally dear to him, and every man should pay equally for its protection; every man's property is equally dear to him, and every man should pay for its protection in proportion to its amount." The society which this rule held in view was early New England society, and the time the last part of the last century. There was at this time a rough equality in respect to property as well as social status, and on this account the principle of apportionment to which Massachusetts statesmen gave their approval would lead to payment for the support of the State in proportion to ability. The same rule applied at the present time would not result in adjusting the burden of taxation in proportion to the relative ability of citizens. It is the new social and industrial conditions which make it necessary to abandon the "cost" and the "value" theories of apportionment, and not the development of a finer sense of justice among men. It is true that a higher phase of social ethics is in process of evolution, and that the necessity of giving expression to the contributory theory of taxation is one of the results of that evolution, but to claim that payment for the support of the State in proportion to ability is a newly developed moral concept would be to cast suspicion upon the rule of apportionment for which we are now contending. It is much more convincing to say—what, indeed, is true—that the equity of the rule that taxes should be paid in proportion to ability has been universally approved by the moral sense of mankind, but that never until recently has there been any need for the formal expression of the rule as the basis of apportionment. It is the complex character of modern industry, its stratification along the line of property rights, and the great disparity of riches, which brings into prominence the principle that taxes should be paid according to ability. Not only, therefore, does this theory of apportionment rest upon the moral sense of the community as it now exists, but it appeals for support to the conscience of the past. The first struggle which arose respecting taxation was to establish the rule that all men should pay something; the question

of the present is to devise a system by which men may be made to pay according to their abilities

One further thought may be expressed with regard to the principle of apportionment now under consideration. It finds an added sanction in the fact that it is the complement of the theory of distribution which both individualistic and socialistic economic philosophy recognises as just and equitable. Communists assert that product should be distributed according to need, all other schools of writers claim that product should be distributed according to efficiency. If, now, the product of the industrial organization is to be distributed according to efficiency, what more natural than that the payment for the support of the State, which alone renders industrial association possible, should be made according to ability? The financial principle of apportionment according to ability is thus observed to be the counterpart of the economic principle of distribution according to efficiency. Whether or not the financial principle would fall were the economic principle to be abandoned need not here be discussed, it is sufficient to notice the close connection which exists between the principle of public and of private economy, and to recognise that each receives a presumption in its favour from the acceptance of the other.

It is believed that the above considerations warrant the conclusion that equity in taxation means the assignment to citizens of their duty to support the State in proportion to their respective abilities. This is by no means a simple conception, as will be shown by the analysis which follows, which has for its purpose to discover in what manner the ability of the citizens to pay for the support of the State may be determined. The point at issue in this analysis is the following: Is ability measured by the amount of property a man possesses or the income he enjoys, or does it increase at a rate more rapid than the increase in his property or his income? Does payment according to ability demand the acceptance of the proportional or of the progressive principle in the apportionment of taxes? The modern tendency, as shown by tax reforms during the past twenty years, is toward greater reliance on the progressive principle;* that,

* Cf. Seligman's chapter on "Recent Reforms in Taxation" in *Essays in Taxation*.

however does not prove the principle to be a sound one, although it may raise a presumption in its favour. The question as thus presented calls for careful analysis.

55. Respecting the Fund from which Taxes are Paid —

Before considering directly the relative merits of these two principles of apportionment it may be well to speak of the fund from which taxes flow, of the relations between income and property as the basis of a tax, and of the various forms in which the progressive principle of taxation may present itself.

(1) *Characterization of Income*—Speaking analytically, all taxes must be paid out of income, and, if properly understood, out of net income. The word income needs no further definition than that implied in the definition of a tax already given, which asserts that a tax is a derivative revenue. The rent, the royalty, the interest, the dividends, the profit, the salary, the wages—these are all funds which, according to the phraseology of contracts, stand for income. It thus appears that an income is a sum of money which comes in to an individual or corporation during a definite period of industrial activity. We may assume this period to be the year. It is then the amount which during the year will come to be at the disposal of the citizen, and which may be used in current expenditures or in an extension of investments. From the individual point of view, therefore, it is the net income and not the gross income to which the State must appeal. It is the income that limits domestic expenditure, and not the income that measures the volume of business, that must be made the source of payment to the State. The phrase "gross income" cannot properly be employed except for a business which has "operating expenses." To accept gross income as the measure of the possible expenditures for consumption in any direction whatever has been the first step to the ruin of many a business man. A tax, therefore, whether in the form of an income tax, a property tax, or any kind of a tax whatever,* must, so far as the individual is concerned, come from the net income, for the same reason that rent or payment of the grocer must come from that fund. This is in harmony with the idea entertained through-

* A possible exception to this statement makes its appearance in connection with the corporation tax.

out this treatise, that a tax is, or at least should be, a necessary item in every domestic budget. It is true that a tax may be paid out of the saved income of past years; but such a practice could not be followed very long without ruin, and on this account the contingency is not recognised in the discussion which assumes an annual payment in perpetuity. The revenue of a State must flow from the product of current industry, and in so far as the State permits this product to be distributed among producers before it demands its share (that is to say, in the case of derivative as distinguished from direct revenue) the fund from which this revenue is derived must be a net revenue of citizens.

Care has been taken to explain this phrase "net revenue" so that its use in this treatise will not be confounded with other uses of the same phrase. We have already noticed in connection with the theory of tax exemptions the claim that a "minimum of existence" should be allowed to the citizen free of tax, and discovered that this argument in favour of such exemptions rests entirely upon considerations of fiscal expediency. The "minimum of existence," assuming for the moment such a thing to exist as an economic category, must include a contribution to the cost of collective living. If then it be true that taxes flow from net income, it is evident that the necessities of physical existence should not be deducted from the year's earnings before the net income subject to taxation is determined. This, however, is in effect done by a large class of writers. "It is confiscation," says Professor Rogers, "to levy a tax on what a man cannot save." His reasoning is the same in kind, though not so clearly put, as that of Justi, who in 1755 wrote as follows: "In the adjustment of taxes great regard must be had to the poor and the less well-to-do subjects, for it cannot be said that these classes earn anything since, even if they obtain their most pressing necessities and their subsistence, it cannot be asserted that they earn anything so long as they have nothing left over"* Whatever may be said in favour of an exemption of the necessities of life from the point of view of an eighteenth-century monarchy, or however important as a means of agitation for the redress of abuses in the taxing system of the time, it is certainly illogical, now

* Quoted from Cohn, *Science of Finance*, p. 329.

that the State is conceived to be the people organized as a government, to define taxable income in such a manner that the cost of government lies outside the normal expenditure of citizens. Net income, therefore, as used in this discussion means the personal income of citizens from whatever source or in whatever amount.

Nor, in the second place, is the phrase "net income" to be confused with the "net product" of the physiocrats, or the "surplus revenue" of the socialists, or the "unearned increment" of the single-taxers. The physiocratic theory of the net product was, as a matter of fact, the forerunner of the minimum-of-subsistence theory in taxation entertained by English economists, although it was developed, nominally at least, in the interest of a State that had impoverished itself by the levy of excessive and inequitable taxes. For the same reason that a manufacturer considers it bad policy to cut down operating expenses so far as to impair the efficiency of his plant, it was regarded by the physiocrats as against the interests of the State to encroach upon the necessities of existence for the industrial classes. Such a policy, it was urged, tended to decrease the net product from which all sterile members of society must live, the State among the rest. It frequently occurs that an erroneous analysis does valiant service in the correction of practical abuses. Such was the case with the pre-Revolutionary theory of taxation, for it showed that the general prosperity of a people is necessary to a full treasury, and in the course of its reasoning it was made clear that an arbitrary taxing system is a burden to trade. No truths could have been more pertinent to the times, and the fact that the analysis by which these conclusions were reached appears strained to the modern student shows more clearly than any other single fact how radical is the change in the ideas of men respecting the nature of the State. There is no need, under modern conditions and in view of the prominence given to equity as a prime requisite in taxation, to make use of the assumption that the source of public revenue is a net product to the industries of the whole people in order to impress upon government the importance of granting to citizens an opportunity to attain economic success.

The theories of taxation which rest on the assumption

that interest and profit are built out of a "surplus value" over the earnings of labour, or that rent is an "unearned increment" to the owner of real estate, likewise fail to commend themselves to the broad view with which equity in taxation is now being considered. The source of revenue to the State through taxes is income to the citizen, and to lose sight of this fact is to invite the patent-medicine financier to exhibit his wares. If social conditions are unsatisfactory, if industrial relations are wrongly adjusted, if the law of private property serves to oppress the propertyless, reform should be addressed to the conditions, the relations, or the laws in the case. It is in the highest degree illogical to suffer the causes of an inequitable distribution of wealth, or of a tyrannous use of private property, to continue, and then to indulge the illusion that the evil consequences may be averted by some peculiar use of the taxing machinery. This is the practical result of a clear appreciation of the source from which the State secures revenue through taxes.

Professor Cohn, who agrees in the main with what has been said, makes use of the word income rather than the phrase net income as indicating the source from which revenue by taxation springs*. The difference is in the choice of expression and not in the content of thought. It has seemed to me important, in making selection of language, to hold in mind the science of accounts, and to adopt the phraseology of the "income account" as drawn up by the book-keeper of a corporation. This will, in the first place, avoid the necessity of explanation when the corporation tax is under discussion; it also expresses clearly the point that operating expenses incident to any industry must be taken out before the income available for any personal expenditure can be arrived at. Inasmuch, also, as the income of one man may be operating expenses in the receipts of another (as, for example, the wages paid by the manufacturer), the use of the phrase net income provides against one source of double taxation.

(2) *Relation of Property to Income*—Another question which must be discussed before considering directly the relative merits of proportional and progressive taxation pertains to the relation of income and property. In general it may be

* Cohn, *The Science of Finance*, Book II., Chapter II.

said that the value of the property is the capitalization of the income that arises from it at some accepted rate of interest, the rate of interest in its turn being affected by the probable permanency of the property, the certainty of the income, and the general speculative conditions which exist. If this be sound, it follows that an income tax and a property tax amount to one and the same thing, except that the rate on incomes must be higher than the rate on property in order that the State may realize a definite amount. It would, however, require that the word property should be expanded beyond its ordinary meaning to thus identify these two objects of taxation. A lawyer or a physician, for example, may have no property in the common use of that word and yet be in receipt of a very considerable income. It would be theoretically possible to capitalize this income and convert it into a property for securing a basis of taxation, but it is simpler, at least for the purpose of discussing proportional and progressive taxation, to reverse the process and to accept income as the basis of comparison. The only danger in proceeding in this manner is that it may lead to the impression that the argument is in favour of an income tax as the best sort of a tax, but the mere mention of this danger will enable the student to avoid it.

At this point another query emerges. Is all property giving rise to incomes of the same sort, or must property itself be classified before the rule of apportionment may be applied? This is important because, if incomes equal in amount are recognised as possessing different economic qualities, it may be that equity will demand a different rate according to the economic character of the income in question. To put this query in a definite form. Is a terminable annuity the same for the purpose of taxation as a perpetual annuity? A promise of \$10,000 a year for ten years is certainly worth less than a promise of \$10,000 a year for ever. The present value of the one on the basis of 5 per cent interest is \$71,078, while that of the other is \$200,000. Why, it may be asked, should not that which is worth more pay more? The answer is that it does pay more. The permanent annuity pays annually for ever; the terminal annuity, on the other hand, ceases to pay at the end of ten years.

In the above case it will be observed that both classes of

income are equally certain, but the reply does not seem quite as satisfactory when urged in favour of rating a personal income as high as an income from property, for a personal income, like salary, profit, wages, is not only terminable, but uncertain as well. The continuance of a personal income depends upon the health and vigour of him who receives it, and on this account would not capitalize for its full arithmetic value; and, more than that, it comes only through continued exertion, while the property income is independent of the exigencies of health or the burden of labour. It seems necessary, therefore, to concede that a strict application of the rule that taxes should be levied according to the respective abilities of citizens will result in a lower assessment of the personal income than of the property income before assigning the rate of taxation. In the application of this rule profit to the undertaker is of course classed as a personal income.

56 Characterization of Proportional and Progressive Taxation—Excepting, then, net income to the citizens as the source from which taxes are paid, and making allowance in the assessment of incomes rendered necessary by the different economic character, and, further, putting out of mind for the present the question as to how incomes are to be approached by the tax laws, we are at last prepared to consider whether the principle that citizens should pay for the support of the State in proportion to their respective abilities demands proportional or progressive taxation.

The difference between a proportional and a progressive tax is doubtless appreciated in a general way, but in order to preclude the possibility of misunderstanding the two forms of taxation will be defined and illustrated. A proportional tax is a tax levied at a constant rate irrespective of the amount of income from which it is paid. If, for example, an income of \$1000 be called upon to pay a tax of \$50, an income of \$10,000 will pay a tax of \$500, an income of \$15,000 a tax of \$750, and so on, the payments being always a definite per cent (5 per cent in the illustration) of the assessed income. Should property be the object taxed, a similar relation exists between the value of the property and the payment. The payment might, for example, be calculated at 5 mills on the dollar irrespective of the amount of property held. If inheritance be accepted as a basis of taxation, the

payment would be in proportion to the value of the estate inherited, the same rate being demanded on a small as on a large legacy. The idea of the proportional tax seems to be that the ability of him who makes payment to the State is measured by the amount of income, property, or capital which he possesses.

The rule of proportional taxation may also be applied in the case of taxes imposed on the manufacture or purchase of commodities designed for consumption, although in order to conceive this to be true it is necessary to look away from the tax object to the tax source, and to consider all the articles of consumption that are included in the list of taxed commodities. A uniform tax of 5 cents per pound on the importation of coffee, for example, while realizing in form the idea of the proportional tax, might, as a matter of fact, necessitate a higher proportional payment from a small than from a large income. That is to say, such a tax would be degressive. One is not, however, at liberty to judge of the principle which underlies a taxing system on the basis of an isolated tax. Each commodity taxed must be considered in connection with the system of which it is a part. Other commodities besides coffee might be taxed, and it is quite possible that when to the tax on coffee paid by all, since this is an article of universal consumption, there be added the taxes on comforts and luxuries from which a man of small income is exempt, the consumption taxes as such would call for a proportional payment from the various classes of incomes.

The same line of reasoning would lead one to conclude that a true conception of the nature of a system of taxation cannot be arrived at except the aggregate of what a man pays for the support of the State (due allowance being made for payments in the form of fees in so far as they are an offset for services rendered) be compared with the clear income which he enjoys. This thought is of considerable importance, as will be seen when the argument that a progressive tax on certain selected commodities is defensible because necessary to make the system as a whole conform to the principle of proportional assessment is subjected to analysis.*

* Illustrations of systems of taxation said to be progressive are numerous. For the plans submitted to the American Congress prior to

It is sometimes assumed that the substitution of the contributory theory of taxation for the benefit theory carries with it the acceptance of the progressive in place of the proportional principle of apportionment "If the benefit theory," says Cohn, "is found untenable, . . . then it follows with the same necessity that the proportional basis of taxation must be abandoned" * Looking at the matter historically, there seems to be some ground for such a conclusion, no matter whether one trace the development of opinion in the expressions of theorists or in the rules of practice Professor Seligman in his monograph on *Progressive Taxation* classifies writers of the last two centuries according to the theory of the tax from which the proportional, the degressive, or the progressive principle of apportionment is advocated; and with the exception of five writers (the most important of whom is Garnier, who advocate progressive taxation as the logical outcome of the benefit theory), and of four writers (the most important of whom is Parieu, who develop proportional taxation from the contributory theory of a tax), they all conclude their analyses in harmony with the generalization quoted above from Professor Cohn The great body of writers range themselves with the one or the other of the two following classes: first, those who hold that the benefit theory leads to proportional taxation; or, second, those who hold that the ability theory leads to progressive taxation.†

this century see my pamphlet, *Taxation in the United States, 1789-1816* For a description of the Swiss system of progressive taxation see *Quarterly Journal of Economics*, Vol I, No 1 This subject is comprehensively presented in Professor Seligman's monograph on *Progressive Taxation in Theory and Practice*.

* Cohn, *The Science of Finance*, p 312.

† It will be interesting in this connection to quote that portion of the table of contents of Professor Seligman's essay on *Progressive Taxation* in which writers on finance are classified. As noted, writers are divided into five classes. The analysis is as follows :

The Benefit Theory Leads to Proportion.

Hobbes, Pufendorf—Sully, Vauban, Petty, Quesnay, Turgot, Mirabeau, Montesquieu, Montyon—Justi, Adam Smith, McCulloch, Senior, Sargant—Mirabeau the younger, Thiers, Girardin, Baudrillart, Chauvet, Ginoulhiac, Proudhon, Dupont, Batbie, Leroy-Beaulieu—Schlozer, Harl, Sartorius, Kroncke, Krehl, Kessler,

It may be of advantage to say a word respecting the character of the exceptions to the above generalization. Garnier's idea seems to be that the benefits of the State, especially those of protection of property, increase more rapidly than property, from which premise it is of course a logical conclusion—assuming a tax to be a payment for benefits received—that the rate for computing the sums due should be higher in the case of a large than of a small fortune. This is progressive taxation. It, however, is manifest from the analysis of governmental functions, or from a consideration of solidarity in the service rendered by the State, that the assumption upon which Garnier's conclusion rests is not true. A man's dependence on the State holds no fixed relation whatever to the amount of property of which he may be possessed, much less does it increase at a rate more rapid than the increase of property.

Parieu, on the other hand, maintains proportional apportionment at the expense of logic, being forced to this by his repugnance to socialism, which he conceives to lie concealed in progressive taxation. Notwithstanding his deservedly high reputation as a writer on finance, one is inclined to imply to Parieu what Cohn says of Rau: "The proportional basis of taxation [with Rau and his followers] is nothing more than an inconsequential conclusion based on their own inclinations, to which they cling in order to avoid the oft-portrayed dangers of progressive taxation."* It thus seems

Kremer, Rotteck, Faucher, Braun, Hock—Compagnoni, Boccardo—Pastor.

The Benefit Theory Leads to Non-proportional Taxation

Gandillot—Bentham, Forbonnais, Steuart—Sonnenfels, Behr, Jakob, Lotz, Malchus, Murhard, Biersack—Chailley, Benvenuti—Sismondi—Condorcet, Garnier, Eisenhart, Judeich—Fauveau.

The Faculty Theory Leads to Proportional Taxation

Bodin, Sheridan, Frend, Parieu

The Faculty Theory Leads to Degressive Taxation.

Mill—Rau, Umpfenbach, Bergius, Pfeiffer.

The Faculty Theory Leads to Progressive Taxation.

Montesquieu, Montyon, Say, DuMazet, Denis, Fauveau—Paley, Craig, Buchanan, Sayer, Buckingham—Schon, Held, Neumann, Schäffe, Suen, Wagner, v. Scheel, Meyer—Pierson, Cohen-Stuart—Graziani—Piernas-Hurtado.

* Cohn, *The Science of Finance*, p. 312. I am inclined to think that Cohn does Rau a slight injustice by his failure to distinguish between

that the exceptions to the generalization that the benefit theory leads to proportional taxation strengthen the impression that the duty of a citizen to support the State increases at a rate more rapid than the increase of his property or of income

57 Arguments for and against Progressive Taxation.—Current analysis respecting the principle of apportionment centres in the question of progressive taxation. No constructive work either in fiscal theories or fiscal legislation is possible without arriving at some definite conclusion respecting it. If proportional apportionment be sound, the fiscal system will take upon itself the colouring of those social relations with which it is in harmony; if progressive apportionment be accepted, the revenue system will be adjusted to a different ideal of social and industrial relations. Nor does the question lie entirely between the acceptance or the rejection of the theory of progression, for there are publicists who aim to realize the proportional principle in taxation by means of the machinery of progression. The literature of taxation shows that this subject is approached from many sides and supported or disapproved for many reasons. It is, therefore, incumbent upon us to classify the arguments for and against progressive taxation and to venture a critical opinion respecting each. We cannot avoid the responsibility of a conclusion upon this question, which at the present time seems to be the turning point for so many schemes of fiscal reform and lines of fiscal analysis.

(1) *The So-called Socialistic Argument*—There are those who regard progressive taxation as a means of bringing about the equalization of property, or of establishing and maintaining those conditions out of which equity in possessions will emerge. The argument which these employ is commonly called the socialistic argument. The end is so clear and the means to the end so direct that we need spend no time in explanation.

Besides this brutal method of approach there are many writers impressed with the idea that an equitable distribution of property is essential to a well-organized society, and who, for that reason, contemplate with favour a progressive tax

“payment according to ability” and payment which involves “equity of sacrifice.”

as one element in a general programme of social reform, or as a temporary expedient during the time that some comprehensive programme of reform is in process of crystallization. These, too, are sometimes called socialists. Professor Wagner, for example, is classed by Professor Seligman as the "foremost scientific advocate of the socialistic theory of progression," and he cites in support of this opinion the distinction which Wagner draws between the purely fiscal principle and the socio-political principle underlying public finance. Professor Wagner, unfortunately, presents this distinction as marking two historic epochs in the development of revenue systems. As an historic generalization this is incorrect, but as a concise method of placing two fiscal principles in comparison with each other it serves a good purpose. The idea of Professor Wagner seems to be that the State should no longer content itself with the raising of an adequate amount of revenue, but in raising revenue should consider broad social and industrial conditions, and employ revenue machinery in such a way as to check any unhealthy influence that may be observed in society, or to bring about those social and industrial conditions under which alone the ideal of the nation may be realized. If now it be conceded that a fair degree of equity in the possession of wealth is essential to the realization of what is best in democracy, and if the application of the principle of progression to the scheme of taxation is adequate to establish such equity, this concession is conceived by Professor Wagner to be an adequate justification of the application of the progressive principle; and, admitting the premises, it is difficult to see how one can evade the conclusion. This reasoning brings to the support of the progressive principle of taxation all those fiscal and social considerations which lie within the concept of organic society, and in so far as the contributory theory of a tax is allied to this conception of social relations it may be regarded as in harmony with the progressive principle.*

* For Professor Seligman's criticisms upon Wagner the student is referred to his treatise upon *Progressive Taxation*, pp 66-70, inclusive. The vigour of his attack seems to me uncalled for, but to show the reason for this conclusion it would be necessary to enter upon a somewhat extended analysis of socialism, communism, and democracy.

Another argument in favour of progressive taxation, closely related to the above, rests upon the assumption that the inequalities of social and industrial conditions are due in large measure to the failure of government to maintain equity of conditions as between citizens. Thus President Walker concedes a theoretic argument in favour of progressive taxation on this ground. He asserts it as an "undoubted fact that differences of property and income are due in no small degree to the failure of the State in its duty of protecting men against violence and fraud." And further, "that differences in wealth are in a measure due to the acts of the State itself having a political purpose, as treaties of commerce, tariffs, currency legislation, embargoes, non-intercourse acts, etc." His conclusion from these premises is that in the absence of administrative objections it would be proper for the State to undertake to redress the evils which have resulted from its own acts of omission or commission by a system of progressive taxation. President Walker, however, as all American students know, was very careful to distinguish between a theoretic and a practical conclusion.

This argument in favour of progressive taxation is presented more exhaustively by Mlle Royer, who takes the ground that it is the duty of the State to compensate individuals for the accumulated results of legal inequalities. "The ideal of distributive justice consists in repairing the inequalities and the wrongs of nature. So far from attaining this end, on the other hand, in the past, legislation was frequently contrary to justice and always aggravated these inequalities and these wrongs. It is necessary at the present time to compensate in a conservative manner and with prudence the pernicious consequences of past legislation." The conclusion from such a premise is that the State ought to impose progressive taxes: and perhaps the only criticism upon it is that if the premise be true the conclusion suggests too weak a remedy.

Many other writers there are whose line of reasoning is similar to that of those referred to. So far as the arguments

Socialism is capable of scientific interpretation and it scarcely seems right to impute to one who has always presented his analyses in a scholarly manner, and whose work is highly scientific, reasoning which, to say the least, is unscholarly and unscientific.

of extreme socialists are concerned it is certainly illogical for them to advocate progressive taxation. Their ideal is of a society in which government is the one great industrial corporation. Their purpose is the establishment of a society that does not recognise private property, or, indeed, a private income except in the form of public salary or public wages. The extreme socialist approves the centralization of industrial power, since this brings the industrial organization more nearly to his ideal. For him, therefore, to advocate such a use of the taxing power as to obstruct this tendency toward centralization is illogical in the extreme. Progressive taxation efficiently carried out would, other things remaining the same, tend toward the equalization of private incomes and result in a more equitable distribution of industrial power. It would be logical for one who defends the institution of private property, and who believes in the theory of voluntary initiative in industry, to advocate progressive taxation as an essential condition to the maintenance of those industrial relations in which his ideal of society may be realized; but for the socialist, whose theory of social organization is opposed to that of voluntary association, such an advocacy is illogical and absurd.

Professor Wagner's argument is not like that of the extreme socialist, inconsistent with itself. His system of thought is discriminating in its application of the theory of governmental industries. His ideal is that the State should be placed at the centre of industrial life, not that the State should absorb all industrial initiative. The essential difference between him and English economists is the point of view from which industrial activity is considered and in the broader motives to industrial activity which he recognises. He may or may not be mistaken in his judgment respecting the extent to which the State should undertake industrial functions, but there is nothing in his system which precludes his use of the argument that the State may employ progressive taxation as a means of establishing and maintaining conditions which are propitious for a normal development of the individual citizen. Moreover, from the point of view of strict logic Professor Wagner is justified in urging the theory of progressive taxation because he does not stop in his advocacy of social reorganization with this peculiar use of the taxing

machinery It is not relied upon by him as the sole means of social reform, but as a check upon the industrial tendencies during the period in which a general scheme of social reform is coming into operation This fact that progressive taxation in the hands of extreme socialists is illogical, while progressive taxation as advocated by the "socialists of the chair" is consistent and, so far as form is concerned, reasonable, is of itself proof that the two schools of thought hold before themselves essentially different ideals The argument in favour of progressive taxation which rests upon the assumption that the taxing machinery should be brought under the influence of ethical and social considerations approves itself to one who appreciates the solidarity of social interests How far it may be wise to depart from the fiscal principle in adjusting a taxing system is a practical and not an ethical question, and on this account its consideration is for the present postponed

Practically the same conclusion may be arrived at with regard to the argument which favours progressive taxation as a means of redressing the evils of bad government in the past Assuming that the plan is capable of realization, no reason exists in the nature of the case against it It must, however, be recognised that this basis of the progressive principle is a somewhat contracted one It is not true that all fortunes are traceable to acts of omission or commission on the part of the State, and if the theory of progressive apportionment has no other basis than the one submitted by Mlle Royer and President Walker it is clear that progressive taxation must be limited to those fortunes which the State is directly responsible for having created This is the weak point in the argument Not only can this theory suggest no rule according to which assessments could be made, but it fails to appreciate that if undue concentration of industrial power is a menace to the established order, the source or occasion of the accumulation is of little importance As a specification under the general heading of politico-social considerations these ideas may have some force; but as an independent argument in support of progressive taxation they are too limited in their application to be convincing

(2) *Progressive Taxation and Equality of Sacrifice*—While it is true that the chief interest in progressive taxation springs

from a desire to equalize industrial conditions, other arguments there are that may be urged in its support. Progressive apportionment is advocated by many writers as a means of attaining equality in taxation. An illustration will make this clear. An import duty or an excise tax in order to be fairly productive must attach itself to the importation or the manufacture of commodities consumed by the great body of the people. This means that these taxes are paid out of modest incomes, and that the proportion which they demand from a small income may be higher than the proportion which they demand from a large income. Such taxes are in reality, therefore, degressive and not proportional, and it is conceived to be necessary to levy unusual or special taxes upon men of large incomes in order to make their payment equitable as compared with the payments of men of small incomes. The progressive income tax, then, or what means the same thing, the special taxes designed to attack large properties adjusted to the progressive principle, are conceived as compensatory duties, and are justified as the only available means of realizing the principle of proportional taxation in the system considered as a whole. The argument pertains to administration and not to theory. It furnishes a justification for progressive apportionment but not for progressive payments.

This argument is sometimes applied in another manner. In the adjustment of customs duties it is quite common to impose a higher rate upon the importation of luxuries than of the necessities of life, and the practice is justified by appeal to the progressive principle. It is impossible to tell with accuracy whether such an adjustment works progressively or not. The probability is, however, that the high import duties imposed upon luxuries, even though they are paid by men of large incomes in addition to their payments upon the necessities of life, will not amount in the aggregate to more than a proportional payment as compared with the payment from smaller incomes. Such an adjustment is progressive in form only. The high taxation on luxuries is justified as a means of realizing proportional taxation. The practical question as to the ability of government to collect an excessive impost on luxuries does not here come into consideration.

Another argument in support of progressive taxation accepts "equality of sacrifice" as synonymous with "equity in payment," and concludes that progressive apportionment is necessary to attain equality of sacrifice. This is an old idea, and one that has been presented under many forms. The most simple expression for it is that the burden of the tax is measured "by what is left after payment" rather than by the payment itself. Assume, for the purpose of illustration, a five-per-cent income tax. This would call for the payment of twenty-five dollars from an income of five hundred dollars, of fifty dollars from an income of one thousand dollars, and of five hundred dollars from an income of ten thousand dollars. If, now, this payment, which is calculated by the rule of proportional and not of progressive taxation, be subtracted from the income, it appears that in the first case there remains four hundred and seventy-five dollars out of an income of five hundred, in the second there remains nine hundred and fifty dollars out of an income of one thousand, and in the third case nine thousand five hundred dollars out of an income of ten thousand. Now, it is asserted that the sacrifice in the three cases is not equal, but that the payment rests most heavily upon him who makes the smallest payment. The idea seems to be that the intensity of desire is greater for the necessities than for the comforts and the luxuries of life, and that a payment which takes from the individual a means of satisfying the pressing needs of rational living is more keenly felt than a payment proportionally as great made from an income sufficiently ample to permit one to enjoy all the necessities of life without thought, and to indulge besides in many of the luxuries. This is the crude way in which the argument is presented, and one cannot doubt, so far as the psychology of sacrifice is concerned, that it rests upon an established law of the human mind.

Scientific support seems to have been given to this argument for progressive taxation by the recent analysis of Austrian economists. This school of writers start from the idea that value is a function of utility, and that the intensity of utility decreases as the commodity in question increases. If this be true, it follows that one's estimate of the importance of any given commodity is always in inverse ratio to the amount of it which he possesses. Progressive taxation on

incomes, therefore, is necessary in order to maintain equality of sacrifice in the payment from incomes. The error in this reasoning, if there be an error, lies in the assumption that men's estimate of money is subject to the same psychological rules as their estimate of consumable commodities. The reason why the value of a commodity to an individual is in inverse ratio to the quantity of it which he possesses is found in the fact that the want to which the commodity ministers is capable of complete satisfaction, and that the intensity of desire decreases as the appetite approaches satiety. This is undoubtedly true for goods that are consumed; is it equally true when money, the representative of commercial power and industrial force, is the object of consideration? Most certainly not. The more money a man has the more he wants, and not unfrequently the last dollar gained is the object of keener passionate regard than the first. It is not possible to apply to money, which is the measure of industrial importance, the same laws of value that one applies to a commodity designed to satisfy needs through consumption. Our conclusion, then, respecting the argument in favour of progressive taxation which proceeds from the theory that taxes should represent "equality of sacrifice," no matter in which form it is presented, is that it is inconclusive. It is not possible to accept a psychological experience as the basis of the rule of apportionment. It is necessary to distinguish between the phrases "ability to pay" and "equality of sacrifice," and to rest whatever rule of apportionment is adopted upon the concept involved in the former rather than in the latter phrase.

(3) *Progressive Taxation and Industrial Development* —The final argument in support of the progressive principle of taxation is suggested by the most common of the criticisms urged against it. It is very properly assumed that a revenue system should not act as an obstruction to industrial or social development; on the contrary, it is accepted as one of the marks of a sound revenue system that it provides the conditions under which the industrial forces are granted the freest possible play. Proceeding from this assumption, most English economists have concluded that progressive taxation would work to the detriment of society by acting as a discouragement to the accumulation of capital and to the exercise of industrial talent. This thought is tersely expressed by

Mill when he says "To tax the larger incomes at a higher percentage than the smaller is to lay a tax on industry and economy" If this be true, the progressive tax cannot be approved, for it would tend to obstruct the development of national wealth, which is at once the measure of both national and individual expenditures

The application of this idea in the hands of English economists is simple and direct. One of the doctrines of English economy is that industry is limited by capital, another doctrine is that wages are in proportion to capital; yet a third which bears upon this question is that capital is the result of saving, and that the amount that can be saved is in proportion to the opportunities offered for acquiring wealth. It is not our purpose to criticise these doctrines, but merely to suggest their bearing upon the question of progressive taxation. It is undoubtedly true that the strict application of the progressive principle would increase the rate of payment for any particular individual until no motive remained for the individual thus taxed to increase his property, and the contention of the school of writers to which reference is made is that this will result in arresting the expansion of industry for the country at large.

Conceding such consequences to be involved in progressive taxation, the opposition of English economists is reasonable and just, but the advocate of the progressive principle denies that such results will follow its application. The causal force for undertaking an industry, he asserts, is the demand on the part of the public for goods or services, and, provided the application of the progressive principle does not tend to weaken this desire, one cannot say that it will obstruct the expansion of industry. It may, indeed, shift the source of supply, for, in so far as it discourages the expansion of an industry already large by imposing an unusually high tax upon an income from such an industry, it will encourage industrial activity on the part of those whose production is relatively less and who on that account are assessed at a relatively lower rate. It may tend to equalize industries; it will not tend to arrest industrial development. This reply to the criticisms of English economists upon the industrial results of a progressive tax is sound for all non-monopolistic industries, and these, it may be remarked, were the industries

which the English economists held in mind when formulating their criticism

This general line of reasoning is capable of further application. Not only is there no danger that national industry will be discouraged by the application of the progressive principle, but there are those who claim that it will receive a decided stimulus. In the first place, as bearing upon this point, it is suggested that the productive years of a man's life, that is to say, the years which from a social point of view are truly productive, are commonly the years before his efforts are crowned with success. A great thought seldom comes to a man after fifty years of age. This being the case, it is not entirely a fanciful argument that a tax which discriminates against established success and in favour of current effort will result in the encouragement of experiment and in the socialization of the achievements of successful experimentation. So long as saving was regarded as the chief if not the only means for attaining industrial evolution it may have been logical to assert that progressive taxation would embarrass the growth of national wealth, but when it is recognised that intelligence, expressing itself in the form of invention and better industrial organization, is the essential productive principle, the line of reasoning relied upon by English economists to controvert the principle of progressive taxation comes to be an argument in its support.

A second argument also in support of the progressive principle is suggested by this same line of analysis. The most serious evil incident to modern industrial life, and an evil which impedes more than any other the rapid development of individual well-being and national improvement, is found in the constantly recurring periods of commercial depression. The conviction seems to be growing that the fundamental cause of this phenomenon lies in the fact that the maldistribution of property in productive machinery brings with it such a distribution of the product of productive machinery that current product cannot be currently consumed. If, now, it be true that progressive taxation imposes a higher payment upon achieved success than upon effort, thus tending to check the further concentration of industrial property and to weaken the motive to industrial expansion on the part of the most successful, it will result in a more equitable division of indus-

trial incomes. This in its turn will cause a diffusion of purchasing power in the community and act as a relief to the stocking of the market

The third application of this line of reasoning reverts again to social considerations. It is the design of progressive taxation to impose special payment upon those who are industrially successful and in this manner to provide the opportunity of success to the larger number. What influence, it may be asked, will this exert upon society? To trace this influence in detail is the work of the sociologist and not of the financier. It may, however, be remarked that, provided the inducements to industrial activity are taken from men at a period of life when they still have energy to respond to other interests and ambitions, the result would not be wholly pernicious. It would not, for example, be a misfortune if municipal administration should fall into the hands of men who had retired from active participation in a business life. A leisure class is from many points of view of great importance to a highly organized society. The difficulty in the past has been that the leisure class becomes sooner or later an aristocratic class, and for this reason has been looked upon with suspicion by democracy. The result would be very different if this class should be based on years and attainments rather than on birth or inherited property. These suggestions will doubtless be regarded as products of the imagination; and indeed they are. They seem, however, necessary in order to present completely the concepts which lie embodied in the theory of progressive taxation. This view of the case also suggests the error of criticisms like that of Leroy-Beaulieu, who says that progressive taxation must be erroneous in principle since its extreme application leads to an absurd result, a criticism which seems to find favour with most systems of progressive taxation, as is shown by the fact that progression stops with a limited application. If progressive taxation may be used as an instrument to bring about such social results as are above referred to, there is no reason why the rate of progression should cease at the time when the tax is likely to render its most efficient service. There is no middle ground. One must believe in the principle of progressive taxation or he must disbelieve in it; and, so far as the arguments urged in its favour rest

upon social considerations, it is clear that they do not allow an exception to be made in the application of the principle when the highest incomes and the largest properties are under consideration

(4) *Conclusion.*—It is somewhat difficult to express definitely the conclusion which should be drawn from the foregoing analysis of progressive taxation. This is not due to the difficulty of appreciating the strong and weak points of each argument as it was presented, but rather to the fact that the final adjustment of taxes must be determined from the administrative point of view. It cannot be questioned that ability to pay is the only just and practicable basis for the apportionment of taxes, or that this ability increases with increasing income at a rate more rapid than the increase of the income itself. Nor can it be doubted that, although a social reform cannot be effected through any conceivable use of taxing machinery, yet the conditions under which a more healthful social evolution can take place than is observed at the present time may result from the manner in which the taxing machinery is employed. This, as well as the idea of equity, induces the mind to consent to the principle of progression. It may further be conceded that the fear entertained by English economists lest the accumulation of capital and the development of industry should be arrested by progressive taxation is not warranted by the facts in the case, but, on the other hand, that the principle of progression judiciously applied will tend to invite experimentation and give an opportunity to energy under conditions likely to be the most conducive to industrial and social development. Each of these arguments considered by itself seems to warrant confidence in the theory of progressive taxation. The difficulty arises when the question is presented in the form of a practical problem. In what manner can progressive taxation be worked out? What is the form of the revenue system which provides for its easy application? Is it possible, in view of the practical conditions to which taxing laws must apply, to make use of this principle of apportionment in the levy and assessment of taxes? It is not the design of the present chapter, which concerns itself exclusively with the theory of apportionment, to answer these questions. They pertain to the practical part of the revenue problem. It is possible

that subsequent analysis will present such trenchant criticisms upon the taxing system as it now exists that the student will be led to demand a complete renovation of the revenue policy. At any rate it will be wise to proceed to the analysis of taxes rather than at the present time to inquire whether or not the principle of progression is applicable to a taxing system. The principle seems capable of defence; to what extent it may be applied can only be determined after making clear the character of the revenue system by means of which it is to be realized.

CHAPTER III.

CLASSIFICATION AND CHARACTERIZATION OF TAXES.

SELECTION OF A PRINCIPLE OF CLASSIFICATION.

TAXES ON INCOME

- (1) Income from Services.
- (2) Income from Property.
- (3) Income of Property.

TAXES ON PROPERTY AS THE SOURCE OF INCOME.

- (1) Theory of Property Taxes.
- (2) Property Classified on the Basis of Income.
 - (a) Property in Person.
 - (b) Property in Land.
 - (c) Property in Capital.
 - α Theory of the Personal Property Tax.
 - β Three Reasons why the Personal Property Tax is Untenable.
 - (d) Property in Wealth Assigned for Use

TAXES ON BUSINESS AS A MEANS OF SECURING AN INCOME.

- (1) License Taxes.
- (2) Franchise Taxes.
- (3) Corporation Taxes.
- (4) Excise and Customs Taxes.

CONCLUSION

58. Selection of a Principle of Classification.—The most serious difficulty in drawing up a classification to be used in a scientific investigation lies in the selection of a principle or characteristic according to which facts may be grouped. Manifestly the most significant quality of the data under observation should be pressed into service, but experience shows it to be no easy task to discover at the outset this character-giving element. Taxes have been classified in many ways, but, without passing these several methods in review, much less subjecting them to criticism, it will better serve our purpose to proceed at once with the classification that fits into

the peculiar conception of the subject entertained by this treatise, for, in every work upon taxation not a compilation of other men's ideas, the principle for classification is selected, either consciously or unconsciously, long before the necessity for a formal classification presents itself. That this is true in the present instance will be recognised as our analysis proceeds

The thought has been presented several times in the foregoing pages that public revenue is a part of current social income, and that taxes represent that portion of public revenue which first existed in the form of private income. The machinery of taxation is merely a means of getting at that income, and the different taxes represent different methods of approach. All the social, industrial, political, or moral results bound up in a system of taxation come about through the psychology of such an attack upon income. This was seen clearly by the old economists, who classified taxes according as they attached themselves to the various constituents of income; that is to say, according as they demanded payment from rent, interest, profits, or wages. In this they were right so far as their method of analysis was concerned; their error lay in their assuming it to be an easy task to determine upon which of the constituents of income a given tax finally rested. The classification here presented, while maintaining this point of view, is based upon the form of the tax rather than upon its incidence. It holds in mind the manner in which income is approached rather than the results which follow that approach. It is not as ambitious as the old classification, but it has this advantage, that it separates a study of the question of incidents from a study of the question of form. Indeed, as will be seen later, it prepares the way for merging the question of incidents of taxation into the larger question of commercial and social results of which it in reality is a part.

Coming now to the classification itself, taxes are of three kinds according to the manner in which they approach the income of citizens and demand therefrom a payment for the support of the State. The law creating a tax may come at income in either of three ways:

First The tax may be levied directly on income.

Second The tax may be levied on property considered as the source of income

Third The tax may be levied on business considered as the means of securing an income

Before proceeding with an analysis of taxes on the lines laid down a word may be said respecting a criticism sure to arise in the minds of those who are familiar with current literature upon this subject What, it will be asked, has become of taxes on consumption ? The answer is, there are no such taxes Taxes usually called taxes on consumption are either "criterion taxes," which are in reality taxes on income, or they are "excise" or "import" duties, which are clearly business taxes All taxes affect consumption Through consumption they affect demand, through demand they affect price; through price they affect profits, through profits they affect the distribution of employment, or, we may say, the industrial structure itself The relation of taxes to consumption is a fundamental relation, it presents itself whenever the State asks money from the earnings of citizens, and on this account it must be regarded as too comprehensive to be made to stand for a particular group of taxes in a formal classification

59. Taxes on Income.—The word income is used in no unusual sense It is the fund by which the domestic budget is supported or from which property is accumulated. No expenditure (the borrowing of money being dropped as complicating the statement, though not changing the situation) and no expansion of one's possessions can take place except it pass through income, and, should one keep a set of books, first make its appearance in an income account Now, it is a peculiarity of some laws which are designed to secure public revenue that they address themselves directly to this income They levy taxes on income and aim to demand a payment in proportion to income at either a uniform or a progressive rate

A tax on income is a very simple tax both in legislative form and in the reasons urged for its support. In form the law demands the cash payment of a certain per cent of the annual clear income of each citizen The payment is supposed to rest where the charge is placed, and in the vast number of instances this will be the case Assuming the ability to

pay to be the just measure of payment, income is accepted as the surest test of ability. In years when business is prosperous the payment would be large, in years of depression the payment would be small. From the point of view of the citizen nothing could be more considerate and no tax more easily borne. The demand of the State would increase or decrease as the fund from which the payment is made increases or decreases. This is not presented as an argument either for or against an income tax, but rather to show the simplicity of the idea underlying it. Speaking logically (not historically), the income tax is the original tax, and all other taxes are complementary to or a substitute for this tax in those points in which it is difficult of application. This assumption at least permits the student to appreciate most easily and naturally the relation existing between the various sorts of taxes.

The chief embarrassment which arises on account of the income tax lies in the difficulty of obtaining the correct statement of income. This is not due entirely to dishonesty on the part of citizens, but to the great variety of forms in which incomes exist, and to the confusion that arises when one endeavours to distinguish between a clear and an encumbered income. Were all men farmers, were the State composed solely of merchants, or were salaries the only form of private revenue, incomes would be homogeneous and the same treatment applicable to all. But in society as it exists incomes are not homogeneous. They do not reflect the same industrial conditions or measure with accuracy the energy expended to secure them. There are at least three different kinds of income, each of which has a character peculiar to itself and on that account demands peculiar treatment. These are as follows:

Income from service.

Income from property.

Income of property

(1) *Income from Service*—The distinction between personal incomes and incomes from property, and the reason for rating the latter higher than the former, have been already presented in the discussion on progressive taxation. Personal incomes such as wages, salaries, professional fees, undertakers' profits, and the like, are both terminable and

uncertain, while rent and interest are by comparison considered as perpetual and certain. This statement applied to rent and interest is not of course absolutely true, but it represents the situation with sufficient accuracy to warrant a distinction in the law of taxation by which income from property is rated higher than income from effort

Another reason also may be urged in support of this distinction. It is not possible in matters of taxation to consider the individual alone, the family is in fact the social unit, and as such should receive consideration in the framing of tax laws. While it is doubtless undesirable that great family properties should be built up, it is of the highest importance that provision should be made out of current earnings against destitution or serious inconvenience of a family on account of the death or incapacity of the head of the household. Industrial as well as social arguments might be presented in support of this assertion, the conclusion from which is that an abatement should be made from the tax on personal incomes as compared with property incomes equal at the least to the premium upon a life policy conformable to the needs of the family in question, its standing in society and accustomed rate of living being taken into consideration.

One might proceed further and show that sociologically, and from the point of view of the relative importance of incomes to families in the different grades of life and employment, personal incomes themselves are not of the same quality as property incomes, but the distinctions to which such an analysis would lead do not so much pertain to the character as to the amount of income. Should it be deemed wise for a revenue system to recognise this distinction, it can more easily be done by applying the rule of progressive rating to incomes of different amounts than to classify incomes and apply the rule of uniform rating to incomes within the class. Nothing new in principle would emerge from such a discussion beyond what has already been suggested in the discussion on progressive taxation.

(2) *Income from Property*—Coming now to a consideration of income from property as distinguished from income from service or employment, yet more serious difficulties arise in the administration of the income tax. Incomes from property do not present homogeneity, but vary in character

according to the property from which they spring. Land, for example, is essentially different from capital, and in equity demands a different treatment. It is universally recognised that social progress works upon rent to increase it and upon interest to decrease it. Rent from a given piece of rent-bearing property grows with the growth of society, while interest from a given amount of interest-bearing capital dwindles with the development of industry. This means that a given quantity of money received as income is no measure of what one citizen should pay for the support of government, as compared with another citizen, without taking into the account the source from which the income arises. This is generally recognised as between personal and property incomes; it is equally true as between property incomes from various sorts of property. And it is pertinent to inquire if the rule of payment according to ability does not demand a different tax adjustment for incomes of different economic qualities. Does it not require, for example, a higher impost on an income that accrues fortuitously to the citizen, which tends to increase "while he sleeps," to employ the phrase of John Stuart Mill, than upon an income arising from property which if used tends to economic deterioration, and if not used ceases to be of value? It certainly seems that these two classes of income stand for economic conditions and social tendencies sufficiently diverse to justify special treatment at the hands of the legislature in the framing of tax laws.

A comparison of rent and interest as forms of revenue by no means exhausts the significant differences between the various kinds of property incomes. That class of income-bearing property called capital is not homogeneous, and the interest accruing from it reflects its variable economic qualities. It is not true, as was assumed in the analysis immediately preceding, that industrial progress depresses interest in the case of all capitals. Capital itself must be classified as capital that is and capital that is not subject to the deteriorating influence of competition. It is true that the rate of interest tends to fall on all capital, but, provided the property upon which the interest accrues can be capitalized at a proportionally higher figure, the fall in the rate may not affect the income. Indeed, it is possible that the capitalization may proceed at a relatively more rapid pace than is necessary to compensate the owner

for the fall in the rate of interest, in which case an income in the form of interest partakes of the peculiar advantages that attach to an income in the form of rent

It is not necessary to pursue this analysis further. Sufficient has been said to make clear the impression which it is designed to leave upon the mind of the student. Not only is there a difference between personal and property incomes, but property incomes themselves reflect diverse economic conditions and are subject to varying economic tendencies. This being the case, the amount of money received during the twelve months is no satisfactory measure of the relative ability of citizens to pay for the support of the State. The conclusion from this analysis is that the theory of the income tax errs in its fundamental premise

(3) *Income of Property*.—The third form in which the income tax presents itself is termed the tax on income of property as distinguished from the tax on income from property. This phrase is designed to suggest the inheritance tax in all of its forms. Many reasons have been urged in support of the inheritance tax as a special tax. By some it is justified as a means of correcting the evasion of taxation during the life of the testator, that is to say, while the fortune bequeathed was in process of accumulation. Others regard it as a probate fee, and still others urge its necessity as a means of preventing permanent inequalities of fortunes. Whatever the degree of truth in these several theories, and others that might be mentioned, it is most natural, as well as most helpful in framing a revenue system, to regard the inheritance tax as a special form of the income tax. That the inheritance is an income to him who secures it there can be no doubt; that it increases the recipient's ability to pay for the support of the State is equally beyond question, while the fact that it is an accidental or fortuitous income to the individual, and from the social point of view represents a transfer of property and not an increase of wealth, supplies a reason for treating it differently in the framing of tax laws from the manner in which the ordinary constantly recurring personal or property incomes are treated. The inheritance tax is peculiar in two respects. First, the rate is usually higher than on periodic incomes, and second, the rate is graduated according to relationship, beginning with a low rate for direct heirs, and increasing as the degree of

relationship becomes less direct. The unusually high rate is due to the non-periodic character of the income, while the variation in rate from direct to remote heirs is justified by the fact that the dependence of the former on the property is not changed by the death of the testator. For remote heirs also the bequest is an accidental gratuity. Both of these distinctions follow naturally from the assumption that the inheritance tax is a form of the income tax. It is a tax on revenue.

60 Taxes on Property as the Source of Income.—The second group of taxes, according to the classification accepted by this treatise, selects property as the object upon which assessments are to be levied. This brings to notice what is technically known as the property taxes, either in their general form or their specific manifestation. The General Property Tax has played and still plays the chief rôle in the revenue system of the several States of the United States, and for this reason is of special interest to the American student.

(1) **THEORY OF THE PROPERTY TAX**—The theory of a property tax is simple. Property is regarded as the source of income, and such value as it possesses rests upon this fact. The value of property is assumed to be the income arising from it capitalized at the current rate of interest, and in so far as this is true, and provided the amount assessed cannot be thrown off for payment on to some one else, it is a matter of indifference whether the government impose its fiscal obligations on property or on income. It is essential, in order to appreciate the economic character of the property tax, as also to provide for its intelligent discussion, that this relation between property and income be clearly appreciated.

It would be an error, however, to assume that as a matter of history the property tax developed along the lines suggested by this classification. Its historic significance goes much deeper, and it may be well, before proceeding with the analysis, to call attention to the conditions under which it originated and for which it seems to have been fairly well adapted. In no other way can its true character be so well presented, and by no other means can its limitations, when applied to modern conditions, be so successfully pointed out.

The form of society immediately preceding the one with which we are familiar, that is to say, feudalism, recognised

land as the basis of the social structure. Land was originally the only "productive" property known; and the significant fact for one who desires to appreciate the development of the property tax is that social duties, as well as social privileges, were in large part determined by the amount of land assigned, whether to the noble or to the serf. This was true of the internal organization of the manors, where labour on the demesne was the "contribution" of the villain to the support of the State; it was also true of the national organization when the lords acknowledged their holdings by rendering military service. It thus appears that feudalism regarded the holding of land as the measure of social service. Not only was this true of the constantly recurring payments, such as labour on the demesne land, or military service to the king, but whenever the king, in order to repel invasion or carry on foreign wars, found it necessary to command larger resources than came to him as the result of ordinary feudal obligations, the supplemental requisitions, which he did not hesitate to levy, were imposed upon subjects in proportion to the land assigned to them, that is to say, in proportion to their property. Scutage, for example, was a land tax on the knight's fee, the tax being a definite assessment on each twenty pounds annual value.* It thus appears that the principle of payment for support of the State in proportion to property is much older than the modern conception of property; and it was necessary that the class system of feudal organization should give place to the idea of political equity for all members of the State, and that the idea of property valuable for the social privileges which it carried with it should be supplanted by the idea of property valuable for the income which it brings, before the modern theory of the property tax could establish itself.

The above explanation of the historic origin of the property tax extends no farther than to suggest how a tax on land came to be substituted for feudal obligations, without necessitating any radical modification of the rule of apportionment. The land tax, however, is a special form of the property tax; it is not the "General Property Tax" known to the statute books of the nineteenth century. The general property tax consists in the listing of all property according

* Dowell, *History of Taxation in England*, Vol. I, Ch. VI.

to its value, and the taxation of the proprietor on the basis of that value. Thus property, real or personal, is converted into money, and its money value is accepted as the basis of taxation. This is something quite different from the first appearance of the land tax, which, after all, was nothing more than the commutation of feudal dues into money payments.

The birthplace of modern taxation, according to Professor Seligman, is the mediæval town. Upon this point he says: "Every inhabitant was compelled to bear his share of the local burdens, his proportion of the scot and the lot. The scot, or tax, was almost from the very outset the general property tax, combined with the subordinate poll tax, exactly as in the earliest days of the New England colonies. The town, as such, generally paid its share of the national burdens in a lump sum, the *firma burgi*. But this lump sum was always distributed among the townsmen in proportion to the property of each. On the Continent it was the same. In the German towns the taxes were at first levied only on land. But at the close of the twelfth century the land tax had already been merged into the general property tax—or, as it was called, the tax on property *in possessionibus, agris, domibus, censibus et rebus quibuscumque*. In some towns it was called simply a tax of so much *per posse* or *pro bonorum facultate*. Most of the German towns by this time combined the general property tax with the poll tax, and in the Swiss cantons the tax was even called the *Hab-, Gut-, und Kopf-steuer*. The only distinction between England and the Continent was that in England the property tax remained for centuries the sole local tax, while in France and Germany local excises or *octrois* were soon added. But for some time at least the general property tax was the measure of the individual's capacity" +

It is undoubtedly true that the extension of the feudal principle of service in proportion to land to payment in proportion to property is one of the results of the development of town life. This is true because in these towns lived the artisan of the middle ages, and, as the process of manufacture developed, property incident to that process presented itself in a visible form. Moreover, the growth of towns marked

* Seligman, *Essays in Taxation*, pp. 43, 44.

an era in industrial development; they were the result of industrial differentiation, their rise was a step in the application of the principle of division of labour. In so far as the work of the artisan was not an incident in the agricultural life of the community, the primitive feudal manor paid him as well as the agricultural labourer in land. His duty to serve (that is to say, the amount of his labour taxes), like theirs, was in proportion to land; and when, through the growth of the towns, he separated himself from land, and secured a livelihood by working exclusively at his trade or craft, it lay in the nature of the case that his property, as well as land, should be made the object of taxation, otherwise this class of citizens would evade all payment for the support of the State. Speaking historically, therefore, the general property tax is the old land tax (which, on its part, struck its roots into the Feudal organization), supplemented by the listing of other property as soon as such property came to have an independent significance of its own.

The above explanation of the general property tax is historically correct, but it pertains to the form rather than to the essence of the tax. Neither the assignment of feudal service, the land tax into which this service was commuted, nor the general property tax which grew out of the land tax, was conscious of regarding property as the source of income. Indeed, confining the statement to England, it was not until the sixteenth century that the industrial significance of property, by which is meant its ability to command an income, took precedence in the minds of men over its social significance. This is what is understood by the student of English industrial history when he says that capital originated in the sixteenth century. Such a phrase does not mean that there were no material helps to labour before this time, but that the capitalistic *régime* of industry, the *régime* that accepts profit rather than product as the test of success, and which imputes a value to property in proportion to the annual profit it bears or income which it guarantees, was not until then consciously recognised by men. The capitalistic *régime* implies freedom on the part of the worker, and property as an instrument of work. It implies the right of contract in business affairs. It conceives of property as homogeneous, its homogeneity consisting in the fact that it bears a value because it is the source

In what manner should property be classified to enable the State to levy its contributions with equal weight upon all? Answering this question directly, property should be classed in two ways—first, according to the nature of the income, and second, according to grade of the property taxed in the orderly development of consumption. Each of these will receive a moment's consideration.

(2) PROPERTY CLASSIFIED ON THE BASIS OF INCOME.—Attention has already been called to the difference in the several classes of incomes, such as personal incomes, rent, interest, and direct use. Universality of payment through a property tax would require that each form of income be crystallized in or represented by a corresponding property, for the dictum of the theory is that the value of property is determined by the capitalization of its income. It follows from this that the general property tax must recognise:

Property in person;

Property in land,

Property in capital,

Property in wealth assigned for use, that is to say, wealth in the process of consumption.

(a) *Property in Person*—It may be unusual, but it is by no means an unwarranted conception, to regard the status of political and personal liberty as the property of the citizen. The essence of property is an acknowledged right of control. He who has the ultimate or final right to say how a thing shall be used, or to enter into a contract respecting it, is its proprietor. A thousand slaves are the property of the master; emancipation transfers that proprietorship to those who formerly were slaves. Emancipation results in the diffusion of property. The more familiar one is with the course of industrial history the more natural will this conception appear. The first step from a condition of status to the *régime* of contract was the evolution of freedom for the serfs, by which they acquired the right of selling their labour; and it was not until this universal proprietorship in self was established that private property in land or in capital was regarded as either possible or desirable.

It is easy to see that an assumption of a property corresponding to personal income is essential to universality of contribution through the general property tax. The income

of the lawyer or of the physician should be capitalized, and the capitalized amount should be listed for purpose of taxation, if equity is to be preserved in the contributions exacted from the several classes of citizens. This, however, has never been done, and for two reasons.

In the first place, the property posited on freedom is not, like land or capital, a commercial property. It never comes into the market as property, for it cannot be bought and sold. The service or the labour is indeed paid for, but the property, which is in the right of control over one's self, is, from the very nature of the State in which personal freedom exists, inalienable. This being the case, there is no way of discovering the value of the property except through the capitalization of the income, and for this reason it has always seemed better as an administrative policy to assess the tax directly upon the income than to posit the existence of a non-commercial property in order to obtain a basis for taxation.

The second reason why property in person has never been listed for the purpose of taxation is found in the so-called "optimism" of classical economy, which for so many years after this species of property came to be of any considerable importance controlled the policy of legislation. According to the views entertained it made little difference how a tax was imposed in the first instance. It would, in the course of time, be shifted and reshifted until equitably adjusted. There was, therefore, no need of analysis. The rule that "the best tax is the old tax" was accepted without discrimination. The financier did not trouble himself about including all property in the taxable lists, for no income could escape payment whether the property corresponding to it were directly taxed or not. Under the influence of such reasoning it was natural that taxes should be levied solely upon the material objects according to their market value, for this was the easiest method of procedure.

At present, however, both legislators and economists are working from the standpoint of a different theory. It is no longer regarded as a matter of indifference what objects are selected to bear the burden of the tax in the first instance, nor whether any considerable class of incomes escape the necessity of direct payment. Proof of this statement may be

found in the history of taxation among modern peoples, which shows a marked tendency towards greater reliance upon the direct income tax. In studying the relation of the various taxes the incompleteness of the general property tax on account of its failure to list as property the capitalized value of personal incomes must not be lost to view.

(b) *Property in Land*—As already remarked, the general property tax first presents itself as a tax on land, and a further investigation seems to warrant the generalization that the only phase of the property tax likely to endure as a permanent part of the revenue system is the tax on land. In England, France, Italy, and the German States the result has been the same, and in such countries as the United States and Australia the forces that make for this result are clearly visible. The reason for this is undoubtedly the great difficulty of listing personal property, so that the practical financier feels it to be necessary to get at the income flowing from such property in some other way, but there is also a reason resting in the nature of the case, why in the common abandonment of the general property tax the tax on land values remains. The value of the land, in so far as it is the capitalization of rent, is a homogeneous factor and may, therefore, be accepted as a basis of equitable assessment. An appreciation of the nature of rent shows this to be true. Rent is a surplus income, and as such contains no factor of cost. It is a return due solely to the fact that the best facilities of production are not adequate to meet the demand for a given product, and that, in consequence, the market price of the product must be high enough to induce cultivation under less auspicious conditions. There is no necessity, therefore, to classify rent for the purpose of taxation. It is a simple quantitative economic category. A given amount of it from one source possesses the same character as a given amount of it from another source. This fact taken in connection with the further fact that rent-bearing property cannot elude the search of the tax assessor will in all probability secure for the land tax a permanent place in all revenue systems.

If the above analysis be correct, it is necessary to distinguish between land and real estate. The former excludes, while the latter includes, improvements. A return upon an investment in land is rent, a return upon an investment upon

land, that is to say improvements, in the form of fencings, drains, buildings, and the like, is interest. Real estate, therefore, stands for both rent and interest, while land stands for rent alone. Now, it is the rent which is a homogeneous quantity, and not interest, and what has been said respecting the permanency of the land tax assumes that this tax will be paid out of rent. Whether or not it is wise for the financier to attempt to separate the two forms of income, or to include, as at present is the case in most of the States, both interest and rent in a general real-estate tax, is a question that cannot be decided except under known conditions. There seems at present to be a tendency for tax systems to treat municipal real estate differently from agricultural lands; the theoretic basis of such treatment being found in the above analysis which regards rent as a simple economic quantity, while interest is conceived as a compound of several factors.

(c) *Property in Capital*—That phase of the general property tax which has to do with capital is the one which in practice has proved to be unworkable. Logically it is necessary that property in this form should be made the basis of assessment as well as property in land; and it was natural that, when the evolution of industry created incomes not connected with agriculture, the accepted rule of taxation should be so modified as to recognise other forms of business enterprise, and to include property incident to these enterprises in the list of taxable objects.

α. Theory of the Personal-property Tax—Originally personal property consisted in the property used by traders and artisans as a means of securing an income through labour, and it is a commonplace among writers to assert that so long as personal property existed in this simple form the theory of the general property tax was fairly well realized. In a general way this is undoubtedly a correct statement, but it fails to pluck the fruit of a ripe conclusion from the significant observation that "the mediæval town is the birth-place of modern taxation," for it fails to recognise that the simplicity referred to was due to the organization of artisans and tradesmen into crafts and guilds, and not to the form of industrial property incident to this phase of industry. The mediæval town, regarded from the point of view of

the nation, was an industrial rather than a political corporation. Its charter was granted on condition that the king's officers need not collect dues from individuals. and, although there was developed within the town a species of local taxation in which personal property was made (among other objects) a basis of assessment, it was not because such property possessed a commercial value in the modern interpretation of that phrase, but because the possession of a certain kind of property indicated the social standing of individuals within the town, and was accepted as indicating their probable incomes. The scheme was workable as long as the towns retained their character of localized industrial corporations, and as long as the crafts and guilds retained their original significance. The scheme failed to work when, individualism having emerged from the disintegration of the guilds, and nationality having resulted from the integration of towns and manorial life, the national government undertook to apply to individuals as citizens the rule of assessment which municipal governments had successfully applied to individuals as members of crafts and trading organizations. It is not, then, the complexity of personal property in modern times, as compared with the simplicity of personal property in mediæval times, which has caused the general property tax to become unworkable; but rather the changes in social structure by which both government and property took upon themselves a new political and social significance. It was easy to nationalize the land tax, the nationalization of the personal-property tax, on the other hand, was impossible because the existence of the nation resulted in the destruction of the towns as collectors of public dues, as also of the industrial organizations within the towns by which those dues were assessed to and collected from individuals. Doubtless the complexity of personal property which follows the extension of the principle of division of labour increases the difficulties attending the administration of the personal-property tax by a national government; but to assert that this is the cause of the failure of the tax is at best but half a truth.

The above generalization shows why European states of the sixteenth and seventeenth centuries never should have incorporated into their fiscal systems a tax on personal pro-

erty, and assessed that tax to the individual proprietor; it does not, however, show the error in theory which underlies the attempt to assess capital as land may be assessed. This must be made clear before such countries as the United States and Australia can be induced to follow the lead of the older civilizations and radically modify, if not abandon, the general property tax

β. Three Reasons Why the Personal-property Tax is Untenable—There are three reasons why the theory of the general property tax is untenable when applied to personal property

First *There is property the value of which is not a capitalized income* According to the theory of the general property tax income is an accrual from property The rate of interest being a given factor, there is a definite relation between income and property, so that taxation on the basis of property demands a corresponding relative payment from income Now it calls for no extended analysis to observe that there is a considerable portion of personal property the income arising on account of which is not a pure income, and therefore its value is not the capitalization of a determinable income A carpenter's tools, for example, are his personal property, but their value is less than the capitalized earnings of the carpenter The chief element in his income is wages, it is remuneration for work done The knowledge of his trade may possibly be accounted to him as an investment, and he should, as already explained, have imputed to him a corresponding property in his person, if the theoretic requirements of the property tax are to be fully worked out. But his wages are commonly regarded, and for the most part are properly regarded, as a direct payment for services rendered, they are not an accrual in the form of interest upon an invested capital To tax a carpenter on the value of his tools, as a money-lender is taxed upon the value of his mortgages, lumps under personal property two things essentially different in their economic character.

Another illustration is furnished by the merchant His property is his stock in trade, and his income doubtless bears some relation to the value of the stock carried, but not only does the value of stock bear no relation to the income of the merchant capitalized at current rates of interest, but whatever

the economic relation existing between the merchant's income and the amount of stock carried, it is one that varies with the kind of goods in question, the size of the place in which business is done, and the personal qualities of the merchant himself

Between these two extremes, the artisan whose income capitalized is far in excess of the value of the property incident to his trade, and the merchant whose income capitalized falls far short of the value of the property he must keep on hand for the prosecution of his business, there is an almost infinite variety of conditions and economic relations of which a property tax takes no account. It is true that no government now professes to tax this class of personal property according to the theory of the property tax. By means of exemptions, adjustments, connivance at arbitrary assessments, compensations and other practical devices, the fact that personal property is not economically homogeneous is in some degree recognised; but the necessity of such modifications and exemptions proves the theory on which the tax rests to be erroneous. The principal argument for the general property tax is its simplicity, in fact, however, the many modifications of the rule occasioned by the desire of legislative bodies to remove the manifest injustices that would follow the strict application of the theory has rendered the fiscal system so complex as to be beyond the ability of man to comprehend. Our conclusion, then, is as follows. The certain relation which the theory of the general property tax assumes to exist between income and the value of personal property incident to the securing of income is a pure assumption, and on this account personal property must be carefully analyzed and classified, and a different rating placed to each class of property, before it can be equitably taxed on the basis of value. What stronger indictment could be drawn against the general property tax as applied to personal property? The chief argument favouring it is its simplicity; to make it a fair tax it necessitates a most abstruse classification.

Second Corporate property is not personal property within the theory of the property tax. The economic character of property depends not alone upon the use to which it is put, or the manner by which its value is determined, but also upon

the way in which it is organized for serving industrial ends. According to the organization unconsciously assumed by the general property tax as it existed when it emerged from the eighteenth century, property stood forth in the person of the individual. It was in a sense an appurtenance to the individual, it being the means by which he gained a livelihood or enjoyed life. It was not represented by credit relations, but consisted, for the most part, in tangible things within the possession of him who was their owner. Since, however, industries have taken upon themselves that form of corporate organization developed during the last half century, this is no longer the case. The owner of property lost his personality as a factor in industry when he assigned his capital to a board of managers, in return for the promise of a definite or contingent income. By this means he ceased to be an industrial factor and took upon himself the rôle of an investor. A legal personality has been substituted for the real person. Corporate property has taken the place of personal property in the industrial organization.

As a result of this change in industrial organization very inadequately suggested in the above paragraph, the general property tax has proved to be at fault in practice, and may be shown to be in error in theory. So far as practice is concerned it has been a most prolific source of unjust and unequal assessments, if not of absolute evasion of the duty to pay for the support of the State. It could not be otherwise, property having been transformed from a visible thing pertaining to the person of the owner into a claim upon the accruing benefit of an organization. Moreover, the development of the corporation has destroyed in part the responsibility which previously existed in industrial affairs. The corporation is not responsible for the individual who assigns his funds to it for management, nor is the individual responsible for the corporation, and it is natural that the duty to pay for the support of the State should be evaded so far as possible by both. It thus becomes clear that corporate property is not personal property within the meaning of the theory of the general property tax when regarded from the point of view of administration.

It is more difficult to explain in a few words how the development of corporations has changed the economic character of

property so that it can be no longer regarded as personal property within the meaning of the tax now under consideration. To this end it will be necessary to suggest the relation between the philosophy underlying the institution of private property and the theory of the general property tax. The *régime* of private property could never have gained the confidence of mankind except upon the assumption that it would result in justice and equity between individuals. Were proof of this demanded, it would be sufficient to notice that both the law of private property and the general property tax in its nationalized form were developed under the influence of democracy, and were coloured by the philosophy of eighteenth-century individualism. It was assumed that commercial forces would guarantee a fair price for goods and a just administration of property; and before the days of machinery, of a world's market, of great industries, or of corporate organization, there was much reason for reposing confidence in such a guarantee. Now the important point for this discussion is that, *in so far as competition works*, there will be a normal rate of interest and an average rate of profit. Both income and property will be in proportion to effort and efficiency; and the capitalization of income will fairly represent the original investment in the property from which the income flows. This being the case, payment for the support of the State on the basis of property will be payment according to one's ability to obtain an income. The assertion is ventured that the individualism of the eighteenth century would have accepted neither the institution of private property nor the rule that private property is a just basis of taxation had it not been assumed that the opportunity to acquire property was unobstructed, and that the income from it was a safe indication of a man's industrial efficiency. This is the meaning which underlies the doctrine of normal interest and of average profit, as also of the theory of capital building which makes so essential a part of English political economy.

Without discussing the extent to which these expectations were realized before the "Industrial Revolution," it is manifest that competition is not at the present time a guarantee of industrial justice where corporations are competitors. A normal rate of interest or an average rate of profit (whether the comparison be made between all industries or between

successive years for the same industry) does not pertain to this form of industrial organization, and, consequently, capitalization does not, and from the nature of the case cannot, conform to the original investment. The railway system of this country, for example, is represented by stocks and bonds to the amount of \$11,000,000,000, while the earnings of the system in a fairly good year capitalized at 5 per cent gives a value of about \$6,000,000,000. Less than 50 per cent of the railway stocks in the United States bear dividends, and still all these stocks have a value. Where industry is organized in the form of corporations many considerations determine value besides the ability of stocks to secure dividends. In many cases property is valuable for the industrial power which it brings to its owner. Indirectly the ownership of such property, as, for example, of stocks that never pay dividends, may be the source of income because it gives commercial advantage of some sort, but in no such way that such stocks can be said to have a value dependent on the annual return accruing from them. We are touching here upon the border of a great question. Sufficient, however, has been said to suggest that the institution of private property, and the industrial philosophy which goes along with it, when developed by a people that holds equity and justice as cardinal principles of social organization, never contemplated a nineteenth-century industrial corporation; and that the general property tax, which was drawn to fit into the *régime* of individual ownership and personal management of industry, finds in the personal property of corporations, that is to say, in the stocks and bonds issued by them, an essentially different fact from the "personal property" of the eighteenth and the first half of the nineteenth centuries.

Our conclusion, therefore, is that personal property is not homogeneous, its industrial character depending, among other things, upon the way in which it is organized. The theory of the general property tax does not apply to corporate property. first, because payment in proportion to property is not payment in proportion to income; and second, because income accruing from such property will probably be a speculative income and as such is incapable of capitalization. There is thus a theoretical as well as a practical justification for the development of special corporation taxes.

Third *Personal property is not sociologically homogeneous.*—

A complete criticism upon the theory of the general property tax would lead to a consideration of the fact that sociologically personal property is not homogeneous. We shall, however, rest satisfied with a single suggestion respecting this point. The idea seems to be gaining ground that property bears a social as well as a personal significance. Its function is not confined to the satisfaction which its consumption affords an individual, but the conception of its use is extended to include the fact that by means of its consumption it ministers to the development of that collective unity called society. While the philosophy of industrial liberalism controlled the minds of men no conflict of interest was acknowledged between the individual and the State in the use of property, at present, however, the development of monopolistic tendencies in certain grades and classes of industries gives warrant for the opinion that the theory of an enduring "harmony of interests," so hopefully urged by the older economists, is at least limited in its application. This is equivalent to saying that property is not homogeneous from a sociologic point of view, and it presents a reason for taxing one class of property differently from other classes of property. This consideration, however, is not necessary for the conclusion that a flat tax on the selling value of property is inapplicable to the present highly organized industrial system.

(d) *Property in Wealth Assigned for Use.*—Partly for the purpose of completing the analysis, and partly to insert at this point the theoretic basis of a discrimination commonly made in the framing of an income tax, mention will now be made of property which gives rise to an income of use rather than a commercial income. In case, for example, one dwells in his own home, he is excused from the necessity of an annual payment in the form of rent. He has chosen to invest in a home rather than make a commercial investment. Should the fiscal laws excuse this property from taxation because it is not the source of a formal income? This question calls for little analysis.

The common practice upon this point may be commended. Whether the domestic income, this being another name for income from use, be regarded from the point of view of an income tax or of a general property tax,

no distinction is made between a domestic and a commercial investment. Were such a distinction made, and the commercial investment only subjected to taxation, an injustice would be done to him whose money is assigned to a commercial use. As long, therefore, as the theory of the general property tax is accepted as the basis of fiscal legislation, the property assigned for the direct use of its owner must be included in the list of taxable property. Or, on the other hand, should income be made the basis of assessment, the income of him who pays rent for a home should be decreased by the amount of rent paid, in order to arrive at the same basis of payment employed in the case of a man who owns his own home. With this cursory remark, property of value because of its use may be dropped from consideration.

61. Taxes on Business as a Means of Securing an Income.—Having considered taxes levied directly on income and on property the source of income, it remains to analyze the third class of taxes, that is to say, taxes levied on business considered as a means of securing an income. The characteristic feature of these taxes is that they are addressed to the business, being levied as a condition for carrying on business, and in many cases in such a manner as to become an element of cost in the business. The income and the property taxes are efforts to secure payment for the support of government in a direct manner from individuals; the business taxes rest, like all payments, upon income, but they are peculiar in that they approach the individual in an indirect manner. They may, indeed, go so far as to ignore the individual.

Of special importance is it to notice that the value of property as a basis of taxation is not formally regarded by the business tax, the relation of payment to property being a fortuitous and not an essential relation. In this manner the chief criticism urged against the theory of a general property tax is evaded. No attempt is made to discover any single characteristic which all businesses have in common for the purpose of basing a revenue system upon it. On the contrary, the heterogeneous character of business, as well as the indirect and incidental aims of taxation, may be fully recognised by business taxes. It is not claimed that business

taxes are simple in character. In this regard, so far as theory is concerned, they stand in marked contrast with income and property taxes.

A second point of contrast should be suggested. Both the income and the personal-property tax fail because of the ease with which both income and personal property may evade the detection of the tax assessor. The business taxes, on the other hand, while they suffer under peculiar disabilities of their own, do at least have this advantage, that they attach themselves to an industrial process which may be discovered, localized, and attributed to some responsible industrial agent. Thus the first step toward the universality of payment is taken when the industry rather than the individual or the property is made the central figure in the revenue system.

It is not possible to proceed further in the consideration of business taxes without subjecting them to classification. There are four general classes, as follows:

- License taxes;
- Franchise taxes;
- Corporation taxes;
- Excise and customs taxes.

It may be necessary in considering the above classes of taxes to be somewhat arbitrary in the use of language, for, whether one consult the dictionaries, the treatises on finance, the interpretation of the courts, or the revenue laws themselves, it is not possible to discover that these terms are used with precision and at the same time in a consistent manner. The following analysis may be accepted as a suggestion for the satisfactory use of terms as well as for the illustration of the several business taxes.

(1) LICENSE TAXES — Under the general heading of license taxes are included all payments which the law makes a condition to the transaction of business or to the following of a profession, a trade, or any industrial calling. From the former point of view a license runs very close to a fee, but it may be distinguished from it in that a fee is payment on the occasion of a service rendered, while a license is a periodically recurring payment. The most familiar illustration of the license is the payment demanded from saloon-keepers for a permit to engage in the sale of malt or spirituous liquors; of hack-drivers or draymen for the right to carry passengers

or baggage within a city; or of peddlers for the privilege of exhibiting their wares in certain places. It might be urged that a "license fee" imposed upon a peddler is a fee and not a license, because it is not paid periodically, but it must be remembered that the periodicity of a business tax is only possible when the business maintains a permanent location, and the fact that a peddler pays many times a year, whereas a local merchant pays but once, is due to the peripatetic character of the peddler's business and not to the purpose of the revenue laws. Should the peddler localize his business his payment would become periodic. The same may be said of license fees for travelling showmen and the like. While the desire to maintain police service is undoubtedly an important consideration in adjusting licenses, the payment is a tax and not a fee.

(2) **FRANCHISE TAXES**—It is somewhat difficult to define a franchise, and a franchise tax is, in consequence, a little elusive. Regarded from one point of view, it allies itself to the license tax, from another, to a corporation tax. The significant fact respecting a franchise is that the right of use, or the privilege which it creates, serves as a basis of a corporate value. The franchise represents a vested interest; it stands for exchangeable property. The value of a franchise is the capitalization of this right of use, or of the peculiar privileges which the franchise grants. The value of street-railway property, for example, does not so much rest upon the cost of the rolling stock and rails as upon the right granted to operate through the streets of a city. A franchise tax, therefore, is a tax upon a property whose value is in proportion to the commercial advantage of some peculiar privilege; a license tax, on the other hand, is a tax imposed upon a business open to competition, and the value of which rests upon an income that can be maintained notwithstanding competition. The writer is well aware that these definitions do not conform to the language of tax laws, or to the interpretations of courts in cases where these terms are used. There is no established definition of a license tax or of a franchise tax; the above distinction is suggested as the one which lies in the nature of the case and which, if acknowledged, would give to each a definite and significant meaning.

The difference between a license tax and a franchise tax is further suggested by noting the conditions which invite their use. A business or an occupation which presents peculiar difficulties from the point of view of police regulation is commonly imposed with a license duty, and it would add to the clearness and symmetry of revenue systems if this class of revenue should be strictly confined to police administration, so far at least as to recognise that the amount and the occasion of the license is not primarily a matter that pertains to public revenue. An equally definite concept can be assigned to the franchise tax. The property to which this tax addresses itself rests for its value upon the income that springs from capital which the State itself has created. The income of a street railway, for example, is of three sorts. It is, in the first place, the interest upon that investment of the company which represents rolling stock, power plant, rails, and other equipment. It is, in the second place, a profit accruing to an industrial enterprise and represents the excess of operating income over operating expenses, due allowance being made for the payment of fixed charges. But, in the third place, this excess of earnings over operating expenses may be more than enough to satisfy the equitable demand of investments and the equitable adjustment of salaries. There is an "unearned increment" accruing to the business, which springs from the right to do business under peculiar conditions. The volume of traffic on a street railway increases with the increase in municipal population, and the receipts of the company on this account grow more rapidly than do the operating expenditures which the increased traffic occasions. Here is an unusual gain due to the growth of the municipality, and since the railway company enjoys through its franchise the exclusive right to operate over the highways, this addition to its net earnings is retained by the company. It rests upon the peculiar privileges granted the corporation.

Now, it is this income to which a franchise tax should address itself, and it is believed that current criticism upon revenue systems would gain in clearness and lead to more practical conclusions if the relation thus suggested should be accepted and insisted upon. One might, then, say that by means of the franchise tax the State taxes its social earn-

ings from the capital which it has created, but which for reasons of public policy it assigns to private parties for administration. The highest use cannot be made of the franchise tax except the partnership relation between a government on the one hand and a corporation entrusted with a quasi-public business on the other is recognised by the revenue system.

(3) CORPORATION TAXES.—A corporation tax is a tax levied upon an industry organized as a corporation. A corporation is the form of industrial organization peculiarly adapted to large undertakings. It is the means by which a business that calls for the collection of capital from many sources, or that entails responsibilities greater than a single individual cares to assume, may be carried on by voluntary association. In the eye of the law a corporation is a legal personality, and takes upon itself the rights and duties of an individual engaged in commerce or trade.

The form under which corporations are organized is very simple. Resting upon a charter granted by the State, corporations present themselves to the industrial world as independent industrial units. They may hold property, enter into contracts, sue and be sued, in short, perform all of the industrial functions which an individual may perform, consistent with the general laws of association and the terms of the charter. Being a legal personality in the possession of property and in the receipt of income, a corporation may be approached by the State for the payment of taxes. The property of the corporation, whether its value rest upon investment or franchise, is represented by the stock which it creates and the bonds which it issues. The capital necessary for carrying on the work of a corporation is not secured entirely by the issue of stock; but the stock having been issued, and the enterprise which it represents having been set on foot, the management secures further capital for the development of the enterprise by placing a mortgage upon the property secured with the proceeds of the stock. Formally, therefore, the stock represents the proprietor, while the bonds represent the creditor; but in reality the aggregate of stocks and bonds represents a permanent investment of capital in the enterprise.

A further distinction must be drawn between stocks and

bonds. The income accruing upon the bonds is a contractual income, that is to say, its amount and the conditions upon which it is paid are definitely stated upon the face of the bond, the income secured from ownership in stock, on the other hand, is a contingent income, the theory being that the stockholder, who in the eye of the law is the proprietor of the enterprise, will receive the profits and stand the losses. A dividend is a contingent income in the sense that it can be claimed only after it has been "declared" by the proper authorities, and in a properly managed industry must be declared out of earnings. But whether the income to the individual be in the form of interest or in the form of dividend, the income itself is a return upon private capital invested through a corporation. It lies in the theory of a general property tax to make stocks and bonds the basis of taxation. These are regarded as personal property and treated accordingly. When one observes the character of this property and the ease with which it is concealed, it is clear that an attempt to apply the theory of the general property tax to corporations must result in the evasion of taxation by a considerable portion of this property. In order to overcome this difficulty, as also to evade the theoretic criticisms as applied to personal property, there is an observed tendency in recent revenue reforms toward the development of special methods of taxing corporate property. This is sometimes done under the form of a corporation tax. It is sometimes made a part of a general income tax, the corporation itself for the purpose of taxation being regarded as a tax-payer. This tendency suggests the significance of the modern corporation tax, and, whether it be regarded as a substitute for the personal-property tax or supplemental to that tax much may be urged in its favour.

The significance of the corporation tax is further suggested by calling to mind the administration of the personal-property tax in mediæval times. It will be remembered that the ease with which this tax was administered was due not so much to the fact that the instruments of trade stood forth in the person of their possessor as to the organization of the mediæval town as an industrial unit. The successful administration of this tax is explained by the fact that each individual had a place in organized industry and on this account could

be approached by the State through the medium of the organization. Since the downfall of mediæval regulations the world, especially the English-speaking world, has passed through a peculiar phase of industrial evolution. Industrial organization, as represented by the guilds and trading bodies of the mediæval towns, gave way to industrial individualism, and this, in turn, brought society back, through the avenue of voluntary association, to the corporate organization of industry. It is evident that the success of a taxing system depends upon the manner in which it approaches the income of individuals, and modern States, following a development analogous to that of mediæval times, are adjusting their revenue systems to the corporate organization of industry, and are seeking for the most acceptable means of making use of modern industrial organization as a means of raising public revenue in an acceptable manner. The truth is that the individual as a proprietor of industrial capital has in large measure been retired to the background, so far at least as large industrial enterprises are concerned. Not only has invisible property come to stand for the visible instruments of production, but the corporation has come to be the representative of the individual. From this it appears that the substitution of the corporation tax for the direct tax on personal property was rendered necessary by the industrial revolution of the eighteenth and nineteenth centuries.

Modern states are, consciously or unconsciously, returning to the method of procedure in mediæval times. They are coming to recognise that the essential principle of modern industrial life is business association, which, it may be remarked, was the essential principle of mediæval times. The form which the corporation tax should assume and the rules by which it should be administered find no place in the present analysis. Sufficient, however, has been said to show the relation existing between the corporation tax as a tax on industry and the income and property taxes as direct taxes on persons.

(4) THE EXCISE AND CUSTOMS TAXES —Another means of approaching the income of citizens through levying a tax upon business is found in the excise duty, by which is meant a duty imposed upon the process of manufacture. It makes no difference whether the industry is taxed on the basis of

its output or on the capacity of the plant; in either case it is properly regarded as an excise duty. Excise duties, as well as tolls and customs, are frequently called consumption taxes, because it is supposed that the amount levied will result in an increase in price and in this manner be finally paid by the consumer. In the majority of cases this is doubtless true; but an investigation into the incidence of taxation will disclose a sufficient number of exceptions to this rule to preclude an identification between excise duties and the so-called "consumption taxes." And, as already explained, the fact that the payment of the tax affects consumption is a characteristic of all taxes, and on this account, if for no other reason, it seems proper to avoid this phrase in a classification of taxes. An excise duty is levied upon a business and is paid in the first instance by him who carries on the business.

Manifestly the first inquiry which suggests itself to the modern student of finance respecting excise duties pertains to their incidence, and for that reason may be deferred to the chapter that follows, in which that question will be extensively considered. The important thing is to recognise that so far as form is concerned an excise duty is a business tax, and that its service in the nomenclature of finance is to suggest a payment which in some manner attaches itself to the process of production, and through this process to the income of citizens.

The last of the business taxes to be considered is suggested by the phrase tolls, octroi duties, customs duties, import duties, transport duties, export duties, as well as others that might be named. In the broad interpretation of the phrase, any tax which attaches itself to the process of transportation is a customs duty*. It is a tax collected from the trader as distinguished from the manufacturer. It is this fact that gives character to the tax. A second significant fact respecting customs duties, and one which is true whether we look at the matter historically or in the light of such revenue legislation as exists at the present time, is that the commodities in question are produced without the jurisdiction of the territory which levies the tax and brought within that

* A tonnage duty is in strict analysis an excise duty, though for purpose of administration it will probably continue to be treated as a customs duty.

jurisdiction for sale. The occasion selected for imposing the tax is that point in the carriage of the commodity from purchaser to consumer when it passes the boundary of the State.

It is not necessary to speak comprehensively of the historic significance of customs duties. They have always been imposed in one form or another, and the ideas which have given character to their administration are doubtless as numerous as the foreign policies of the governments which imposed them. The reason for this lies upon the surface. Inasmuch as they attach themselves to foreign commerce, they constitute a very important condition under which such commerce is carried on, and the nation which consumes foreign commodities has it in its power to influence a foreign policy by encouragement or discouragement of the import trade. Thus the customs duty may be a retaliatory measure, or indeed a measure designed to coerce a foreign policy. The privilege of import also may be offered in exchange for the privilege of export, and upon the basis of this relation there may be built up a policy of reciprocity. The customs duties, also, must, from the nature of the case, exert a powerful influence upon the development of home industry. Whether brought under the influence of the principle of free trade, of reciprocity, or of protection, the industrial life of a people which make use of this form of raising revenue must adjust itself to the conditions established by the revenue laws. It is this fact which renders the administration of customs duties so difficult. It thus becomes evident that the administration of customs duties opens up a broad field for investigation and analysis. For the present, however, it is only desired to state clearly the nature of this tax. It is a business tax, and as such attaches itself to trade rather than to manufactures.

62 Conclusion—The foregoing classification of taxes, and the analyses by which this classification has been accompanied, have a very direct bearing upon the selection of taxes for the purpose of constructing a revenue system. Setting aside for the present the considerations which lead to progressive rather than proportional taxation, it is evident that an equitable revenue system, while it demands payment from all classes in society, will avoid so far as possible duplications of taxation; that is to say, the same income should not

be attacked by two or more parts of a revenue system. It may be assumed, other things being equal, that that revenue system is equitable which attacks each and every income by some one form of taxation. This, at least, would avoid duplication, and substitute simplicity in form for the complexity which at present exists. As a suggestion for attaining this very desirable end the following proposal is submitted which rests upon the foregoing analysis of taxes. The suggestion may be presented by means of three propositions, as follows:

First Inasmuch as the only orderly incomes not represented by property or business organization are incomes which accrue on account of personal service, the income tax should be limited in its application to this class of incomes. To this should be added the inheritance tax, which is a tax on income of property and which rests upon considerations peculiar to itself.

Second Inasmuch as land is the only form of property the source of an orderly income commercially homogeneous, the property tax, if used at all, should be limited to a land tax.

Third. The chief reliance of the revenue system should be the business taxes, use should be made of the license tax, the franchise tax, the corporation tax, and the excise and customs taxes according to the fiscal needs of the government and as determined by the commercial and social conditions of the people.

CHAPTER IV.

CONCERNING THE MANNER IN WHICH TAXES WORK.

THE SHIFTING AND INCIDENCE OF TAXES.

- (1) The Use of Terms
- (2) Incidence and the Laws of Price.
 - (a) Goods Produced at Uniform Cost.
 - (b) Goods Produced at Expanding Cost.
 - (c) Goods Produced under Conditions of Monopoly.
- (3) The Income Tax

THE INDUSTRIAL RESULTS OF TAXES.

- (1) General Results Working through Consumption.
- (2) Three Special Cases
 - (a) Taxes may Increase Income.
 - (b) Taxes may Cheapen Production.
 - (c) Taxes may Reduce the Level of Profit.
- (3) Taxation and Valuation.

RELATION OF TAXATION TO OCCUPATION AND INVESTMENT.

TAXES AS A MEANS OF ARTIFICIAL SELECTION.

- (1) Taxation and the Moral Reformer.
- (2) Taxation and the Social Reformer.
- (3) Taxation and "Protection."

THE present chapter changes slightly the point of view from which the general question of taxation has thus far been regarded. Having considered the nature of a tax, the employment of the taxing power, and the peculiar relation of citizens as taxpayers, and having analyzed the various kinds of taxes, it now becomes our task to inquire how taxes work. This, it will be observed, approaches the problem from the point of view of the social interest, it holds in mind the process of social evolution, and includes within its inquiry the broad question of social utility. The analysis itself will be minute and technical, but the bearing of the analysis is comprehensive and general. It presents a line of observations

unless there is a corresponding receipt by the government, but were one to judge by the literature of the subject, any disturbance in manufacture, sale, or consumption resulting from the imposition of a tax should be counted a payment. The error underlying this conception may be made clear by an illustration. Suppose a tax to be imposed on the sale of meat. The butcher must either pay the tax out of his income, or add it to the price charged for meat. Should he pursue the latter course he would lose part of his trade, and through curtailment of sales reduce what otherwise might be his clear income. Now, it is certainly an unwarranted use of language to say that the butcher pays the tax, or indeed any portion of it, because it decreases an assumed income and prevents him from obtaining less than what, independently of the tax, existing commercial conditions might lead him to expect. He is doubtless inconvenienced because of the tax. He will be obliged to readjust his business calculations on account of the tax. He is keenly conscious of the fact that the government demands for itself part of the money that previously came to him in the purchase of meats, but he does not pay the tax. One must admit the truth of this statement when it is observed that the same commercial results would follow, so far as the butcher is concerned, should the government by some other means take to itself an equal amount from the fund assigned to the payment of meat bills in the domestic budget of customers. He might, then, continue to offer his meats at the old price, but his sales would be curtailed, and his prospective income would be reduced, just as though he had raised the price of meats to cover a corresponding tax imposed upon his business. It thus appears that a tax may be completely shifted, so that the manufacturer or trader is entirely reimbursed for the sums paid to the government in satisfaction of revenue laws, and still he may feel the inconvenience of the tax levied. A study of the results of taxation covers not only the question of tax payment, but the ultimate consequences of such payments as well, it is, however, essential that the student should distinguish between the question of incidence and the question of commercial results.

(2) *INCIDENCE AND THE LAWS OF PRICE*—As a first step in disclosing the manner in which taxes work in a community

it is necessary to inquire by whom taxes are paid. This is a question for the economist rather than the financier, since it pertains to the conditions under which and the extent to which a tax becomes an element in the cost of goods or the price paid for services rendered. With one modification this treatise follows the analysis of the classical school of economists. It accepts the view that taxes are either direct or indirect, a direct tax being defined as one the payment of which does not incorporate itself in the price of any particular commodity or service, while an indirect tax is one the payment of which is carried over, either in part or in full, to the consumer by being incorporated in the price of consumable goods. From this it follows that the question of tax payment must conform in its analysis to the economic laws by which normal prices are determined. The student is referred in this connection to Mill's discussion of the laws of price.

The price-making forces in a free industrial society are commercial supply and commercial demand, and what is known in classical economy as the three laws of price are nothing more than a statement of the way in which these forces work under the three possible conditions of production.

(a) *Goods Produced at Uniform Cost*—The first condition holds in mind "commodities which are susceptible of indefinite multiplication without increase in cost." In general manufactured commodities are produced under the conditions here implied. Ten thousand yards of cloth can be produced at a given cost, and the cost per yard for manufacture will be neither increased nor diminished because there is demand for the production of eleven thousand yards; or, what amounts to the same thing so far as the law of price is concerned, should this increased demand permit a better organization of industry and a consequent reduction in cost, this reduction will tend to become universal for all producers. No barrier exists, in the nature of the case, to the indefinite increase of goods of this class. Under such conditions there can be no permanent "differential gain" independent of the personal qualities of undertakers. The phrase "average cost" comes to have a definite commercial meaning and will, as a result of competition for sale, tend ever toward the actual cost. The normal price under such circumstances is the cost price,

and the law of price for commodities of this class is that the market price tends always toward the normal price.

What is the nature of a tax which by any of the many possible methods of legislative procedure attaches itself to the production of goods of this class? The answer to this question is simple. Such a tax would be common to all producers. It would be recognised by all as a permanent element in cost, and, being both universal and permanent, would incorporate itself in price. The manufacturer would not pay the tax, although it may be collected from him by the agent of the State, for, adding the tax to the price of the commodity which he produces, he would reimburse himself by selling his goods at an increased price. The consumer pays the tax in the same sense and to the same relative extent that he pays for the raw material in the article, or the wages expended in its manufacture. All taxes, therefore, on manufactured goods not produced under conditions of monopoly, or on the process of manufacture or sale of such goods, or which in any way enter into the conditions of production as a permanent and universal element, are indirect taxes, and their incidence rests with the consumer of the goods.

(b) *Goods Produced at Expanding Cost*—The second case presented by the economists pertains to "commodities which are susceptible of indefinite multiplication, but not without increased cost." All agricultural goods are included under this head. These are goods subject in their production to the "law of diminishing returns." The most propitious conditions for production, that is to say, the conditions where it costs the producer the least, may not be adequate to meet the current demand, and, consequently, less favourable conditions, that is to say, conditions under which it costs something more, must be accepted in order to bring upon the market an adequate supply. Nature presents obstacles to some producers of this class of goods which she does not present to others, and the price must so adjust itself as to offer adequate inducements to producers to enter upon the less favourable conditions of production, and to overcome the more serious obstacles that present themselves. Under such circumstances there can be no "average cost." On the contrary, there are as many different costs as there are different conditions for produc-

tion; but, inasmuch as these conditions are permanent, by which is meant that competition has no tendency to wipe them out, the price of the goods in question will be adjusted to the highest of the permanent costs. The second law of price, therefore, is that the market price for goods produced under the conditions of the "law of diminishing returns" tends to the cost of those portions of the necessary supply which cost the most

What, we may now ask, is the nature of a tax which attaches itself to the production of goods of this class? Our answer is that it depends upon the manner in which the tax is assessed. It is clear that, under the conditions described, an unusual gain, called a rent, a royalty, or a differential profit, arises to all producers except those confined to the most unfavourable conditions of production. If, now, this rent or royalty or differential gain be made the basis of a tax, the price of goods will in no manner be affected, inasmuch as, there being no rent or royalty at the margin of cultivation, such a tax cannot alter the conditions of cost at the point where price coincides with cost. This, in a word, is the reason which leads all economists to consent that a tax on rent is a direct tax, and cannot be shifted from the owner of the land (or whatever by its possession brings rent) to the consumer of the products of the land. Such is the first answer to the question asked.

In case, however, the tax is so levied that it applies uniformly to all land, some other element being made the basis of the tax than the annual rent or the value of property, the question must be answered in a different manner. Since the tax attaches to the process of production where production costs the most, this being the process where cost determines the normal price, the tax will become a new element in cost. It will increase the cost and consequently enter into the price. Such a tax will be an indirect tax and be carried by the price through all subsequent manufacturing or commercial transactions until it is paid by him who consumes the goods as a final product.

It seems, then, that a tax on the value of land, or on the value of any property which gives a differential gain, is a direct tax; while a tax on land according to area, or on the process of agriculture, or on the product of the agricul-

tural industry, such taxes being universal and uniform, is an indirect tax. The former is paid out of the income of those who own the land, the latter out of the income of those who consume the products of the land.

(c) *Goods Produced under Conditions of Monopoly*—Besides the two conditions already described, goods may be produced under the conditions of a more or less strict monopoly. By a monopoly is understood any condition of production in which competition fails to guarantee the consumer a price gravitating toward either an average cost or a highest cost of production; that is to say, all processes of production that do not fall under the one or the other of the cases already named are monopolistic in character. The analysis is exhausted. If price tends toward neither the average cost nor the highest cost, but is determined without regard to cost, the goods in question must subject themselves to the third law of price, now about to be stated.

Although Mill recognised monopoly price and discussed it as a phase of commercial supply and commercial demand, the monopolistic organization of industries as we see it in the last half of the nineteenth century had not sufficiently developed to arrest the attention of his keen observation. The recognition of this class of goods at present is imperative in order that the laws of price may reflect the realities of industrial practice. The normal effect of competition under the conditions of free economy is to drive price towards cost (the average or the highest cost), but in the case of monopoly-produced goods competition, although present in certain of its forms, is not the controlling consideration in the determination of price. Prices are, on the contrary, determined by general commercial considerations, a conclusion that may be formulated as follows. The law of price for monopoly-produced goods will adjust itself to what the traffic will bear. This law is the commercial expression of many psychological principles which it has been the task of economists to analyze anew during recent years. It is sufficiently accurate to be worthy the name of an economic tendential law, and its recognition is essential for one who attempts to follow out the incidence of taxes imposed upon monopolistic industries.

Two cases of monopoly production present themselves.

The first is that of a simple monopoly, by which is meant a monopoly in an industry that, so far as its industrial nature is concerned, is like an ordinary industry, but, because of some legal privilege, such as exclusive right to manufacture, is free from the competition of other producers. Goods produced under the protection of a patent may be taken as typical of a simple monopoly. The second form of monopoly does not rest on a legal privilege or on any arbitrary advantage over competitors, but upon the nature of the industry in question. An industry superior to competitive interference because of the volume of the traffic which it commands is an illustration of such a monopoly. In such an industry cost decreases relatively with the increase of business, and the industry that exists has, on this account, an advantage over the industry of the same class struggling into existence. These are the industries subject to the "law of increasing returns" as compared with ordinary industries which, in their production of goods, are subject to the "law of constant returns." The railway industry is an illustration of this second class of monopolies. Assuming stability in rates, operating expenses do not increase as rapidly as the increase in gross earnings due to the increase in traffic. A new company with light traffic cannot compete on equal terms with an old company that enjoys a dense traffic, and on this account the competition which exists in the railway industry is not such as to guarantee a price tending toward cost. The importance of this distinction between arbitrary or natural monopoly on the one hand, and the monopoly that rests on the peculiar nature of the business on the other, will shortly be made apparent.

In the case of goods made, or of services rendered, under the conditions of a monopoly, price will settle at the point which secures the largest demands consistent with the highest net profit. That point can only be determined by experiment. Demand will increase as the price falls, and so long as the increased net returns incident to increased sales exceed the loss of profit due to a fall in price, it will pay the producer to lower the price.* The results prove the traffic to have been

* No attempt is made in this connection to explain the fluctuations in demand on account of the change in price, as this would lead too far into an abstruse economic analysis.

capable of bearing the lower price. There comes a point in the price movement of every commodity at which a further reduction will not occasion as great a gain on account of the increased sales as would be the loss resulting from the lowering of the price on assured sales. It is at this point that the fall in price will be arrested, and here it will remain until some change takes place in demand, or in the conditions of production, by which the established relations are disturbed. This is the highest price that traffic will bear consistent with the most profitable management of business.

How will a tax which attaches itself to the process of production of such goods affect the price? Will it be paid by the producer or by the consumer? Will it be a direct or an indirect tax? The answer is that it will not be paid entirely by the producer or by the consumer; it will rather gravitate towards the one or the other according as the demand for the commodity in question is an elastic or an inelastic demand.

As illustrating this statement it may be well to add a word respecting the meaning of the phrase "payment of a tax." In the case of a tax on rent the payment is made from the income of the owner of the rent-bearing property. His income is reduced by the payment, and there is an end of the matter so far as payment is concerned. It is true that a reduction of his income impairs his ability as a consumer, and in this manner the tax works back upon the amount of general commodities that can be sold, and upon the extent of profit or the amount of industry in the country; but the payment of the tax lies with him who receives the rent. In the case of a tax upon manufactured goods produced in a free market, that is to say, under conditions in which competition may effect its normal results, the same general conclusion may be arrived at, with the exception that in this instance the consumer pays the tax. The consumer's income available for the purchase of commodities is reduced by the full amount which the State collects, and, as in the case of a tax on rent, the commercial influence of such a payment is exerted through the decrease in the purchasing power of the community for general goods. The recoil of the tax payment is not confined to the producer of particular goods upon which a particular tax is levied, for it is evident that

the producers of these goods must retain the average rate of profit as compared with other occupations, and they will not consent to deprive themselves of an income less than that obtained in the lines of business with which they compare themselves in order to keep a larger custom [†] The tax may occasion a shifting in occupations, but this adjustment having been accomplished, the same relative profit or income will be established (though not the same price relations) as before the tax was imposed

It is also evident, looking at the matter from the side of the consumer, that the tax which raises the price of a particular class of goods will not reduce the consumption of those goods to the full amount of the tax; it will rather cause a readjustment in the amounts apportioned to the several chapters of the domestic budget. Money which before went to the purchase of other goods will now be transferred to strengthen the fund depleted by the tax on the particular commodity in question, and this will react upon the production of all goods and not confine its influence to the production of the goods taxed. Our conclusion is, therefore, that the incidence of a tax is arrested at that point in its shifting where the result of the payment becomes general rather than particular in character. So far as one can trace a difference in the relative rate of profit secured by the producer upon whom a special tax is imposed as compared with other producers, he is justified in asserting that a tax has not reached its final incidence, to go beyond this, however, would be a misuse of the conception of tax payments and a misapprehension of the theory of incidence.

This distinction having been grasped, there is little difficulty in appreciating the nature of the tax that attaches itself to the process of manufacture or sale of monopoly-produced goods. As already stated, it is partly a direct and partly an indirect tax, and the ratio of these two qualities to each other depends upon the elasticity of demand for the goods in question. This will become clear if we trace the effect of a newly

* The average profit here referred to is the rate of profit as determined by general commercial conditions, it must not be confounded with the differential profit to undertakers on account of their varying grades of industrial skill. For the result of a tax on industries which show a difference in the undertakers' returns see pp. 404, 405.

imposed tax. The price before the tax is all the traffic will bear. It has adjusted itself to the largest sale consistent with the highest profit. Either a higher or a lower price will reduce the profit, the elements of cost of production remaining stable. Now, a tax is a new element of cost and requires a new adjustment of price. The goods will not be offered at the old price, for, although in this manner their consumption would not be impaired, the profit to the producer would be reduced by the amount of the tax. On the other hand, should the tax be added to the price the consumption would be curtailed and the gains or profits of the producer would be decreased. Since the tax introduces a new element in cost, experimentation in price-making must be undertaken anew, and the result will be the determination of a price adjusted to the new conditions. Sales will be curtailed by the increase of price, and profits also will be reduced as compared with the previous rate of profit. So far as the increased price rests with the consumer, it will be followed by the general results that always follow the payment of taxes, so far as it results in the decrease of profits, it rests with the producer. It will cause no shifting of capital or of occupation, as in the case of goods produced at normal profit, because the profit is still above the normal rate notwithstanding the tax. Such a tax, therefore, is shared by producer and consumer. In case the commodity supplies an urgent need so that its utility is highly estimated, demand will be but slightly affected by the rise in price, and the ability of the producer to shift the tax will be relatively great. In case, on the other hand, the goods in question are of little significance in the accustomed standard of living, demand will be very sensitive to price, and the producer's ability to shift the tax will be correspondingly decreased. But in any case the tax on goods produced under monopoly will be shared by the two parties.

Attention was called to the fact that monopolies are of two sorts: the arbitrary monopoly and the monopoly incident to the nature of the industry. So far as taxes are concerned the former of these monopolies commands the situation more perfectly than the latter, since the effect of raising the price to recoup the tax is limited to the loss of trade. This is equally true of a monopoly of the second sort, but in addition to this result an industry that depends on the volume of traffic

for its rate of profit, because the larger this traffic the less is the ratio of operating expenses to gross income, must calculate upon the effect of the reduction of traffic upon the per cent of net to gross earnings. To express this in another way, such an industry will not only suffer in the reduction of its sales should it add the tax to the price, but, by virtue of reduced sales, will also suffer in the reduction of the rate of profit upon such sales as it retains. This being the case, an industry administered under the law of increasing returns is less able to throw off the tax imposed upon it than an ordinary legal monopoly. Indeed, one might almost conclude that such a tax cannot be shifted, that it is retained as an element of cost to the producer.

(3) **THE INCOME TAX**—The foregoing analysis upon the incidence of taxation has confined itself to tracing the result of the land tax and of business taxes. The only class of taxes which remains is taxes on income. It is evident, from the line of reasoning already pursued, that a tax on income must be a direct tax. It can have no effect upon the price of any particular commodity, or upon the rate of profit in any particular industry. The reaction that may be attributed to it will be of a general and not a particular character, and this, according to our use of the phrase, proves the income tax to be a direct tax. The only possible exception to this statement presents itself when a poll tax or a class tax is imposed at so high a rate as to impair the accepted standard of living for the wage-earning classes. Such a tax would doubtless result in an increase of wages, and through wages the cost of production or the price of service. Besides this, however, the generalization admits of no exception.

Our conclusion, then, respecting the incidence of taxes is as follows:

An income tax is a direct tax.

A land tax is a direct or an indirect tax according to the manner in which it is levied.

A business tax is indirect for all industries and occupations subject to competitive control, but for industries carried on as monopolies it is partly direct and partly indirect, the adjustment varying with the elasticity of demand for the goods in question.

64. The Industrial Results of Taxes.—Having eliminated

from the discussion the question of tax payment, we are now prepared to consider the broader question of the manner in which taxes work. There is nothing peculiar in the influence of tax payment as such upon the industrial activities of the State.

(I) GENERAL RESULTS WORKING THROUGH CONSUMPTION—Tax payments form an item of expense to the citizen, and the only way in which they can touch general industries is through curtailment of demand or encouragement of supply of those services or commodities furnished by private enterprise. Should the payment be a constant amount from year to year, or a constant proportion of social income, industries would adjust themselves to established fiscal conditions and would continue without any conscious appreciation of the government's demand for money. Whether or not this would be an advantage depends upon the peculiar needs of the people at the period under consideration. It is only when some radical reform is made in the tax policy, either in changing the amount demanded by old taxes or in levying taxes in some new form, that the influence of tax payments upon industries becomes apparent.

The nature of this influence has already been referred to in tracing the incidence of taxes, and is familiar to the student of economy. It may be illustrated by reference to an ordinary commercial transaction. Should rents for dwelling-houses rise or fall from an assumed standard, incomes meanwhile remaining stationary, the fact that a higher per cent of ordinary expenditure takes the form of rental payments would quickly be reflected in general industrial organization. Forms of consumption previously indulged in would be curtailed, and the consequent reduction in demand would necessitate reorganization in the order of industry. Now, a tax is like rent in this particular, that it is a fixed charge upon a given standard of comfort. What is spent in the support of the State cannot be spent in the support of private enterprises, and inasmuch as the State fixes the amount of its expenditure in an arbitrary manner, it follows that the general industries of the country must content themselves with a development that can be supported by what is left of the income of the people after public demands have been satisfied.

In all this there is nothing peculiar. The industrial effect

of any radical modification in the taxing system would be similar to that sure to follow should a change in fashion, or the development of a new taste, disturb the established relation of demand and supply, especially if this change were of such a sort as to shift demand from one class of producers to another. The appearance of the bicycle presents an illustration which will make clear the analogy. This machine provides a new pleasure to a very considerable class in the community, and has disturbed accustomed expenditures. Piano-makers, tobacco manufacturers, theatre companies, and the producers of other analogous pleasures complain that their business is curtailed on account of the expansion of the bicycle trade. The industrial disturbance resulting therefrom is very considerable and must be followed by a readjustment of investments and occupations. In the same way a modification of the tax policy by which the income of one class is relieved at the expense of another class will be followed by important industrial consequences. Capital will be discharged from the service of those upon whom are imposed the new demands and pass to the service of those who are relieved of payment. The transfer of capital implies the transfer of labour, and thus a certain number of employers and employes will be obliged to learn a new business as a result of the changed tax. This leads to a most important conclusion. The burden of a new tax, or of a modification of an old one, cannot be measured by tracing the payments which they occasion, the true burden is borne by those who must readjust their business to conform to the new commercial conditions resulting from the tax. It is similar in kind to the burden resulting from a new invention, though unfortunately it cannot be subjected to the severe commercial ordeal by which the desirability of a labour-saving machine, as compared with old methods, may be determined.

The practical lesson to be learned from the above is that a taxing system to which the industries of the country have adjusted themselves has logically the right to urge the argument of presumption. Under ordinary circumstances the fact that it is in possession of the field should be final against innovation. Nothing can be worse than continuous meddling with tax laws. The time comes in the life of every nation when reforms are necessary, but in judging of those reforms

no statesman will fail to weigh the industrial burden imposed by the necessity of industrial readjustments

(2) *THREE SPECIAL CASES*—It will be observed that the above line of reasoning assumes a stationary social income and an established distribution of income among the several classes. It assumes also a uniform rate of profit and a constant amount of capital. But these assumptions may not be correct, and, as matters are observed to work among energetic peoples, probably will prove to be incorrect. The industrial public is not devoid of will or of purpose. It is essential, therefore, that our analysis take into consideration the conscious efforts of men to lighten the burden of tax payments. There are several ways in which the levy of taxes may affect industrial conditions so as to modify in part the rigour of the foregoing conclusions. Three of these will be mentioned.

The levy of taxes may result in raising the income of the purchasing public.

The levy of taxes may result in reducing the cost of production

The levy of taxes may result in reducing the level of average profits

(a) *Taxes may Increase Income*—The amount of income which a nation enjoys is very largely a question of motive and of opportunity. A tax cannot, of course, originate motive, nor can it create opportunity, for motives lie deep in the character of the nation, and opportunity depends on physiographic and commercial conditions. A new tax, however, may incite to greater activity on the part of the people and consequently serve as the occasion of an increase in income, provided it be levied in such a manner as to stimulate industrial enterprise. It must be remembered that a tax is always levied in the presence of an established standard of living, and an increased demand on the part of the State presents to the citizen the alternative of suffering deprivation of accustomed comforts, or of employing greater skill or increased labour in industry. It is no argument against this claim to say that a man must always choose between unsatisfied wants and increased exertion, and that consequently the levy of a tax makes no change in the conditions under which the motive to industry presents itself. McCulloch very truly asserts that "man is not influenced solely by hope, he is power-

fully operated on by fear. Taxation brings the latter principle into the field, and to the desire of rising in the world implanted in the breast of every individual the increase of taxation superadds the fear of being cast down to a lower station, of being deprived of conveniences and gratifications which habit has rendered all but indispensable, and the combined influence of the two principles produces results that could not be produced by the unassisted agency of either " *

The fact that a tax levy may energize industrial activity is no justification of the levy of taxes, nor can a tax on this account be regarded as in itself a blessing. Activity is only reasonable when it results in some definite advantage, and should the State have no need of the money, it would, under ordinary conditions, be foolish to demand it for the sake of inciting citizens to work harder than they otherwise would work.

(b) *Taxes may Cheapen Production*—A tax may, in the second place, result in cheaper methods of production by inciting producers to invention and more profitable organization. The fund from which the tax is paid is in this case created by the reduction in the cost of manufacture. It seems of the highest importance to the manager of an industry to maintain his accustomed sales. With producers as with consumers fear is a stronger stimulus to exertion than hope, and for that reason one is permitted to say that an industrial undertaker will put forth greater effort to hold a market once gained than to gain a more extended market. It must also be remembered that the adoption of new machinery or the introduction of new methods of production is not infrequently the result of some unusual occurrence in the conditions under which the industry is carried on. Notwithstanding commercial competition the sentiment is strong among the business men of letting well enough alone. It is probable that every manager of an important industry knows ways by which production might be cheapened, but hesitates, in the absence of any compelling reason, to undertake the experiment. Especially is this true of large enterprises where the routine of administration engages to the full the ordinary energy of the manager. How frequently does it occur that a strike among labourers,

* McCulloch, *Taxation and the Funding System*, p. 10.

happens that nations fall into industrial lethargy, or that certain classes of workers, through ignorance or hopelessness, fail to avail themselves of the best industrial methods. Under such circumstances it may be well to apply the lash of taxation. The line of reasoning is the same as that followed by Arthur Young, who advised the landlords of the last century to raise their rents, believing that no other means remained to induce tenants to educate themselves in better methods of agriculture. This is undoubtedly a dangerous doctrine, because the policy it proposes can with great difficulty be wisely administered; but in an analysis of the possible workings of taxation it deserves mention. Taxation brings the principle of fear into the industrial field. It is not, indeed, a steady, constant, healthful principle like that of hope, but it is undoubtedly true that fear of retrogression is stronger as an industrial motive than hope of progression, and, provided the policy be wisely administered, the financier may confidently expect that a part at least of the payment demanded by a new tax will be met by reduction in the accustomed cost of producing goods, and not out of the economies practised in the accustomed lines of expenditure.

If taxes properly levied may be the occasion of industrial progress, it is equally true that unjust and burdensome taxes are followed by industrial retrogression. History offers many illustrations of this truth. But it should be noted that the depressing influence of taxes is for the most part due to excessive demands and unjust methods, or to the conviction that the interests of the taxing body are foreign to the interests of the tax-payers. It does not lie in the nature of just taxation to depress industries.

(c) *Taxes may Reduce the Level of Profit*—There is a third avenue along which the pressure of taxation may show itself in the industrial sphere. It may result in reducing the average rate of profit, and through the influence of this modification tend to increase the normal size and possibly the average efficiency of industries. When considering the incidence of indirect business taxes it was learned that the average rate of profit in the community might be reduced through the curtailment of sales on account of the fact that a tax attaches itself to the income of customers. This conclusion rests upon the assumption of an average rate of profit in a community,

and upon the idea that the reflex of a tax which curtails the amount of income available for the purchase of goods is uniform upon all producers. This assumption, however, is not quite correct, for it ignores the personal element in the problem. Some undertakers are more skilful than others and are on that account able to secure a higher return with the same amount of capital. For these a slight reduction in the rate of profit would not be a serious affair; but for those who are conducting their business on the margin of incapacity even a slight decrease in returns would occasion the abandonment of their business. The incompetent cannot support the addition of the tax to the cost of production, and the effort on the part of the more competent, who enjoy a differential profit above the average or normal rate, to retain their customers by paying the tax will drive the relatively incompetent business managers to the wall. Customers, however, must be supplied, and it is evident that this supply must come from an expansion of the business of the more successful undertakers, so that, in the long-run, they will not suffer in income by the reduction in the rate of profit. They will gain in increased sales what they lose in increased cost.

The burden of a tax that works in this manner rests upon those incompetent producers who were not able to maintain themselves under the new conditions of competition. This burden does not express itself in money payments, but in the fact that certain men who before were independent industrial factors have lost their independence, and have been forced into the ranks of labourers in the employment of their more able rivals. Industrially this is a permanent gain to society. Financially, also, it commands approval because the tax has so worked upon industry as to create the fund from which it is paid; that is to say, it has resulted in a reduction of the cost of production not followed by a corresponding reduction in the market price of goods sold, the difference going to the State as a tax. The loss, if there be any loss, shows itself in the disappearance of certain centres of competition. The effect of the tax which impinges on profits under the conditions described is the same as the effect of trades-unions when they raise wages at the expense of a rate of profit. Both the tax and the demand for increase in wages succeed in taking something from the established rate of

profit, and they do this at the expense of the relatively incompetent undertaker. Both intensify the tendency toward large industries. Whether or not the result justifies the means does not here come into controversy.

(3) TAXATION AND VALUATION.—We cannot close this discussion upon the industrial results of taxation without calling attention to the effect of taxes on the value of income-bearing property that may be bought or sold. Land is such a property, as also stocks of an industrial corporation, or the franchise upon which a corporation operates. In all these cases the commercial value of the property is equal to the capitalization of the accepted income at the assumed rate of interest. Land, for example, which pays a rental of two dollars per acre is worth twenty dollars per acre if interest is ten per cent. Now, it is evident if the value of property is equal to the capitalization of the income arising from it, that any reduction of the income will tend to reduce the value of property by an amount equal to the capitalization of the reduction. The purchaser of such property recognises that it is imposed with a permanent charge, and, in calculating what he can give, will capitalize only that portion of the amount left to him after the charge is paid. Suppose, for example, interest being ten per cent, that land worth twenty dollars per acre without a tax be imposed with a tax of twenty-five cents per acre, it will then give to the purchaser a free income of one dollar and seventy-five cents, and not of two dollars, as would have been the case before the tax was imposed, and the purchaser will consequently bid no more than the capitalization of this amount, or seventeen dollars and fifty cents per acre for the land. This line of reasoning applies to all income-bearing property that may be bought and sold, and, taken in connection with what has been said respecting the influence of taxes upon profit, leads to a generalization of universal application. Inasmuch as taxes are paid out of income, or out of funds which independently of a tax would be counted an income, it follows that industrially they will affect either a reduction in the market price of the income-bearing property or a reduction in the rate of profit or interest. It thus becomes evident that the financier is obliged, in tracing the industrial results of a tax, to consider its influence upon com-

mercial values as well as upon the demand for commercial goods

The fact that a tax may be capitalized and reflected in values has been made the basis of that strange theory of incidence known as the capitalization or amortization of taxes * According to this idea he pays the tax who owns the property in question at the time the tax is imposed To revert to the illustration given above, the tax of twenty-five cents per acre on land, which reduced the value of land from twenty dollars to seventeen dollars and fifty cents per acre, was paid in lump by the original proprietor of the soil at the time the tax was imposed, that is to say, the tax of twenty-five cents per acre was capitalized at two dollars and fifty cents, and to this extent the government became a joint owner in the land. The student will not be misled by this line of reasoning if he holds in mind the interpretation placed by this treatise upon the phrase "payment of a tax." It is true that the purchaser of property under the conditions assumed takes it subject to the duty of paying the tax It is also true that he who owns property at the time a new tax is imposed must suffer a readjustment, either in its value or in the rate of interest at which its value is calculated; but the purchaser of such property is not excused from an annual payment out of the commercial income which his ownership in such property brings him. This effect upon values is nothing peculiar. Any new tax causes a readjustment in the industrial order—a readjustment which shows itself either in the demand for goods, by which general industries are brought to conform their production to the revised domestic budgets; in the rate of profit, in which case relatively incompetent undertakers are forced to the wall; or in the readjustment of values of income-bearing property To admit that the capitalization of a rent charge demanded by the State in the form of a tax frees subsequent purchasers from a tax imposed on land values would be equivalent to the admission of all that is claimed by the advocates of the single land tax The commercial workings of a tax must not be confounded with the annual payment of a tax

65. Relation of Taxation to Occupation and Investment.—It may be accepted as a general principle that men

* Seligman, *On the Shifting and Incidence of Taxation*, p. 52.

choose the occupation offering the greatest return for the least effort. All things being taken into the consideration, it follows from this that a system of taxation so far as it is capable of shaping the industrial structure does so by opposing obstacles to success in certain occupations, or by offering unusual encouragement in others. To understand how a tax may become a condition in the choice of investment or of occupation the thought that commodities are competitors for the expenditure of the free social income, and that the relative price at which they may be offered is important as an element of success in this competition, must be fully appreciated. In case the tax adds to the current price of one article and not to that of another the public will demand somewhat less of the taxed article and somewhat more of the article untaxed. This is inevitable if the articles in question are interchangeable in their use, as, for example, gold and silver, beef and mutton, cotton and woollens; and it is also true, but in a less marked degree, when goods do not compete directly for ministry to the same want. To understand, on the other hand, how a tax may encourage the investment of capital in a chosen industry it is only necessary to call to mind the protective system of import duties, which in one form or another has been practised by statesmen wherever communities or states have recognised the importance of commerce to political power or to national strength.

With regard to the relation of taxes and occupations it is sometimes asserted that a just *régime* of taxation should leave industries relatively to each other in the same situation as before the tax was imposed. Could this be done the tax would have no social results, except such as might arise from the diversion of a part of the social income to the support of public administration. The important question is, however, can this be done? Is it possible for a system of taxation to be neutral as between the varying commercial interests? On this point there are two opinions.

By some it is urged that all industries should be taxed in a uniform manner. Universality of taxation and uniformity in the percentage which a tax bears to other elements in the cost price of commodities are regarded as the means by which society is permitted its natural development. This rule, however, if applied could not accomplish the desired

result, for it assumes as true what is in reality false, namely, that wants maintain a uniformly relative intensity under relatively uniform changes in price. Assume, for example, two commodities, the one worth ten cents and the other fifty cents per pound. Assume, further, that a twenty-five per cent tax be imposed upon both and that the conditions are such that the tax must be added to the price. The former article would then demand twelve and a half cents, the latter sixty-two and a half cents, per pound. Now it is evident that the commercial demand for the two articles in question would not be relatively the same as before. Should they be in any way interchangeable in use it is certain that part of the demand that previously went to the higher priced article would turn to that of lower price. If, on the other hand, the articles in question minister to wants of an entirely different grade (and this is the situation which presents itself to the financier when called upon to consider a "horizontal" increase or decrease of the rate of taxation) a uniform rise in price of all commodities would undoubtedly tend to shift demand from those which minister to the wants of later appearance in the order of social development to those of more primitive growth. It thus becomes evident that the financier cannot, by so simple a plan as that of a uniform tax levy on all values, avoid the necessity of considering the influence of taxation upon the industrial and social structure of the State.

The second opinion to which reference was made rests upon the admission that taxes, however levied, must exert a direct influence, and upon the assumption that, because this is true, it is the part of wisdom to reduce that influence within the narrowest possible limits, and to give it play under conditions that are easily understood. The chief criticism offered upon a universal tax at uniform rate is that it quickly passes beyond the ability of man to comprehend. In view of this fact it is suggested that no more commodities or classes of interests should be included in a tax levy than are absolutely necessary to provide an adequate basis for obtaining the required revenue. Simplicity in taxation is conceived to be essential to an intelligent opinion respecting the way in which taxes work, and simplicity is to be secured by a judicious selection of the objects taxed. There is no better illustration of a complex and incomprehensible revenue system than the

tariff legislation of the United States It levies import duties upon goods that make up the country's exports as well as upon those that contribute to the normal imports of the nation's commerce, it taxes raw material as well as the manufactured product, and the manufactured product itself is taxed at many stages in the process of its manufacture; the rate imposed is determined in part by considerations of revenue, in part by the desire to grant "incidental" protection, and in part for the purpose of prohibiting the imports of selected articles; the rules of rating are numerous, overlapping each other in many cases and resulting in a confusion of instructions that necessitate a board of appeal in continuous session; the text of the law makes a book of one hundred and fifty pages, while the law and its interpretations used by the officials as a guide in the performance of their duty is a volume of several hundred pages A law of this sort cannot be comprehended It is beyond the ability of analysis to trace even its financial workings, much less its industrial results; and it is clear that the results which would follow a uniform change in established rates would be as unintelligible as is the law itself. The internal revenue system, on the other hand, furnishes an illustration of a simple law It levies its excise duties on a few carefully selected processes of manufacture, and the manner of its working is comparatively clear and simple In this regard it is a type of what a tax law should strive to be

It may be urged that a system of taxation resting on selected articles would be unjust as between the producers of taxed and untaxed goods, but such a conclusion overlooks one important fact. Equity in taxation does not demand uniform taxation of all industries Its claims are satisfied by uniformity of taxation within that class of industries that produce what may be termed "competing" commodities If beef is taxed, mutton should also be taxed, because both minister to the same want, and should the beef producer raise his price to meet a tax payment he would lose his customers to the raisers of sheep. Because meats are taxed, however, is no reason why a corresponding tax should be levied upon the manufacture of furniture, for meat and furniture do not, except in a remote degree, come into competition with each other This principle is a fundamental one

and should have the mastery in guiding the selection of the objects of taxation. The theory of a single tax may not be sound, but it is essential that the prejudice in favour of a universal tax must be broken down before a practical and rational revenue system can be formulated. Such industries as are similar in their industrial character and social function should be classed together and treated alike; and, the entire range of taxable objects being thus grouped, the selection of a group for the purpose of taxation, or of determining the rate or the method of taxation for the groups selected, becomes a comparatively simple matter. The general conclusion, then, is that it is impossible to frame a taxing system which does not tend to create, to perpetuate, or to intensify class relations so far as these are dependent upon occupations and upon the investment of capital, but the theory of universality in the tax levy being abandoned, and the taxable objects being properly grouped, the financier may proceed with some degree of certainty as to the results of the system which he adopts.

66. Taxes as a Means of Artificial Selection — The fact that a taxing system cannot be neutral as regards the investment of capital and the direction of employment has led to certain extreme views respecting the ability of government to control social evolution. Thus moral reformers aim to influence character by levying heavy duties on the manufacture and sale of goods conceived to be injurious to character, social reformers see in taxation the means of correcting the evils of unequal distribution of wealth; while the advocates of protection believe that social as well as industrial evolution is intrusted to the hands of the financier. These opinions are not content with the incidental advantages that arise from a judicious use of the taxing power, for so great is the emphasis which they place upon moral, social, and industrial aims that revenue comes to be for them a secondary consideration. No one can deny the right of a sovereign people to use governmental machinery as they see fit, but it must be the deliberate judgment of the student of history that serious mischiefs result from an attempt to subject revenue machinery to a principle of action entirely foreign to the revenue system.

(1) **TAXATION AND THE MORAL REFORMER.**—The moral

reformer who seeks to check the consumption of injurious commodities by rendering them dear has the best case of the three classes of schemers referred to. He acts upon the well-known law of supply and demand, and, since the articles he selects for unusual duties are few in number and the conditions of consumption comparatively simple, he is in a position to test with some degree of accuracy the result of his experiments. Moreover, the failure of his scheme, should it fail, does not involve serious consequences to the revenue system, and so great is the prejudice of the public in favour of the moralist's argument that the financier will probably withdraw his objections to what he must regard on strict principle as an unwarranted use of revenue machinery. In doing so, however, he begs the newly born science of Sociology to assume full responsibility for the experiment.

(2) *TAXATION AND THE SOCIAL REFORMER*—The suggestion that fiscal machinery should be used as an agency for establishing and maintaining an equitable and an economic distribution of wealth cannot be so readily dismissed, for all propositions of this sort must be comprehensive in their application, and a mistaken opinion respecting them might jeopardize the flow of adequate revenue. It is not claimed that the possibility of disaster is final against such proposals, for the possibility of permanent advantage to the social structure is also present. It is, however, essential that the financier should protect his revenues from bizarre experiments, and on this account before he can consent to place taxing machinery at the disposal of social reformers he is obliged to consider their plans as an economist or a sociologist might consider them.

Most prominent among the schemes by which the distribution of property is to be corrected is the progressive income tax, but it is not necessary to arrest our analysis at this point for a consideration of this scheme. Its error lies not so much in the application which it makes of the progressive principle of apportionment as in its selection of the object to be taxed. The limitations of an income tax as an universal tax have already been presented, and it would be necessary for one who argues in favour of establishing a more equitable and economic distribution of wealth by means of the progressive income tax to answer the objections which

have been urged against the income tax as such. The advocacy of the progressive income tax seems to be the resort of reformers who are bold in language but timid in thought.

It has been proposed also that a franchise tax and a corporation tax should be administered primarily with a view to industrial and social readjustment, and it is probable that these taxes will become an agency in the hand of government to assist in the working out of a better social organization. They touch industry at the point where the chief difficulty of modern society lies. And, inasmuch as fiscal analysis points toward the assignment to these taxes of an important rôle in the fiscal system, it is just that the financier should hold prominently in view their secondary or indirect results. Should he, however, place too great emphasis upon social reorganization he incurs the danger of distorting his revenue system.

The only other suggestion of sufficient importance to arrest our attention is that a single tax on real-estate rentals should be substituted for all other taxes. The argument urged for this sweeping fiscal reform is that in this manner the labour and the monopoly problem will be solved without further attention from the State. The conclusion granted, no one would care to withhold his approval from the scheme. The criticism that the annual rental value of real estate does not equal in amount the annual public expenditures would not be final against the plan, for, should this prove to be the case, the rental tax might be supplemented by a few other taxes. The point at issue pertains to the social results claimed for the single tax on land values. If the tax on rental values would work in the manner claimed there is an end of the discussion. The fiscal system must be placed at the disposal of the social reformer.

The argument urged in favour of the single land tax is simple in the extreme. A tax on the rent of land to its full amount would destroy the speculative value of land, and land would, therefore, become common property. Such is the argument. If by this is meant that the State would become the contingent proprietor of the land the assumption is true, and there may be reasons, indeed there are reasons, which induce even conservative persons to grant that land, when placed to certain uses, is in a peculiar

sense a fit object of extreme taxation. But this is not the point at issue. The question is, will a transfer of proprietorship in land from the individual to the State make "free land" in the sense that the labourer will always have the alternative to work for an employer at wages offered or to create his own wages by working on land?

When the problem is presented in this manner there is but one answer. Land is no more accessible for agricultural purposes when its full rental value is demanded by the State than when the interest for its purchase money is demanded by the money-lender. Any one who can guarantee the interest on a sum of money equal to the capitalization of the annual rent can secure land under the existing system of private property. What more can he do should the State become the proprietor of the land and demand from the occupier annually a tax of one hundred per cent upon the rental? The conclusion is inevitable. A tax on rental value to its full amount could not change the level of wages or establish a natural law of wages, or enlarge the liberty of the worker. As a proposition for solving the labour problem, and of effecting in this manner a great social reform, the single-tax theory does not bear the test of analysis. It may be dismissed, therefore, without inquiring as to the effect of the plan on revenue.

(3) TAXATION AND PROTECTION — Perhaps the most troublesome of all the schemes for bringing social evolution under the direction of tax legislation is that advocated by "Protectionists." According to this plan capital and labour are directed to the production of goods that might otherwise be secured from foreign producers. This is to be done by means of a tariff duty levied on the importation of such goods, the importation being obstructive or prohibitive according as the rate of duty is relatively low or high. The home market is thus reserved to home producers and, unless the nation is willing to forego the consumption of the goods in question, factories must spring up for their production at home. The ability of the legislator to direct in this manner the investment of capital and labour cannot be doubted, nor can the fact that such "encouragement" of industry exerts a decided influence upon social evolution be seriously questioned. It is, therefore, incumbent upon the student of finance to fa-

miliarize himself with the claims of the advocates of protection and to inquire how a system of protective duties does as a matter of fact work.

The only theory of protection drawn so as to meet the requirements of scientific presentation is that of Friedrich List in his treatise entitled *The National System of Political Economy*. Whatever may be said of the industrial analysis underlying this book, it is from the formal point of view comprehensive, logical, and self-consistent. The treatise is important, also, because of the part which the policy it advocates has played in the nationalization of the German people, and because of the influence exerted by the ideas with which it is in harmony in the tariff policy of the United States. Without stating, much less deciding, the question of priority as between Friedrich List and Henry Carey, or of expressing an opinion respecting the obligation of List to the American System of Protection as expounded by Henry Clay, we shall proceed at once to an analysis of this theory. The ideas of List are especially pertinent to the line of treatment followed in this chapter, because as a theory they rest upon what its author claims to be a law of social evolution.

List's argument for protection is an argument involving three terms, as follows:

First. There is a natural order in social growth to which all peoples must conform in their evolution from savagery to civilization. Assuming the pastoral state as a starting-point, it being a social condition just one step removed from savagery, the next stage in evolution is that of agriculture; this is followed by manufacturing for the home supply, which in its turn is followed by manufacturing for foreign commerce.

Second. While the above is the natural order of development, and while it is true that this social evolution may perhaps ultimately be accomplished by all peoples of vigour and energy, the process of development receives a decided check at its second step by the fact of trade between peoples of inferior and superior industrial standing. Or, to put this explicitly, the step from the Agricultural to the first Manufacturing stage is seriously retarded by freedom of trade.

Third. From the above premises it is concluded that if

a people desire to attain the highest phase of social development, and to realize the benefits of a justly balanced industrial organization, the law-making body must, at the proper time in the growth of national life, prohibit, for a period, the importation of goods manufactured abroad. This might of course be done by a direct prohibition of foreign trade, but for many reasons governments have always chosen to do this by means of a system of protective import duties.

The above argument may be comprehended more perfectly by noticing two general facts that lie involved in its reasoning. In the first place, it is evident that protection as conceived by List pertains to one step only in social evolution, and is defended as a temporary and not as a permanent policy. The period of protection must be preceded by a flourishing foreign trade, in which the surplus of agriculture is used to pay for the products of foreign factories, since there could not otherwise be developed a sufficiently imperative demand among the people to lead to the establishment of home industries should the foreign supply be cut off. It lies in the theory to assert that the burden of protection, which appears in the higher immediate cost of goods, is the price paid by the nation for its education in the art of manufacture. It is conceived as an investment to bear a dividend when, the education having been completed, the nation may come into the enjoyment of the profits of a flourishing foreign commerce. It thus appears that freedom of commerce must follow as well as precede a period of protection. Protection is defended as a temporary and not as a permanent policy; indeed, to make it permanent would defeat the evolution which protection is designed to assist.

In the second place, the object of protection being the education of the nation in manufacturing skill, and the cost of this education being an expense justified only by the ultimate advantage which it brings, it is evidently sound policy to relieve the process of manufacture of all unnecessary embarrassments. No tax, for example, should be placed on raw material, for such a tax would tend to embarrass the development which it is the design of the protective policy to foster. The granting to agricultural industry, also, a protection like that granted to manufacturers is, for the same reason, a mis-

conception of the idea upon which the policy of protection rests

In the case of a single tax on land it was necessary to analyze the social claims made for it by its advocates, for the tax itself has never been tried, but in the present case there is ample material for judgment in the experience of nations that have undertaken to foster their industrial and social development by means of protection. It is to that experience that appeal is now made for support of the assertion that no government has yet shown itself wise enough and strong enough to administer a protective policy in harmony with its assumed theory of social evolution. In theory protection does not become a source of positive advantage until it gives place to freedom of commerce, in fact after a nation has once tasted the stimulus of protection commercial freedom is either impossible of attainment or can be attained only through a struggle so great as to mark an epoch in financial legislation. In theory protective duties should be high when first imposed and decline as nations learn the lesson of manufacturing skill, in fact they begin with a moderate charge and mount higher and higher each succeeding year. In theory the burden of protection, that is to say, the cost of the nation's industrial education, is borne by the agricultural industry, or by such elemental manufacturing industries as arise normally in an agricultural community, in practice, especially where government rests upon popular favour expressed through the ballot, the policy of protection quickly drifts into the illogical and self-destructive policy of an "all-round protection." In theory, a definite market being guaranteed the producer, an industrial society fostered by protection should show a steady and uniform development, in fact the chief mark of such a society is instability of industrial conditions.

It is not difficult to explain why the experience of nations with the protective policy fails to harmonize with the protective theory. The persistence of the practice long after the nation is educated in manufacturing skill arises from the fact that a tariff law, so framed that foreign manufactures are excluded from the home market, becomes one of the conditions under which the production, manufacture, and sale of goods are carried on. The assignment of capital and labour

to the various lines of industry, the extent to which machinery is used in production, the localization of industries, indeed everything that gives character to industry, comes under the influence of customs legislation. Even the value of the manufacturing plant depends in part upon customs laws, and, although a protected manufacturer cannot on this account urge the argument of a vested right, the government is disinclined to deprive him of a value due to the protection which it previously granted. Under such circumstances the business community, which always conceives its interests endangered by sweeping reforms, and whose views on public questions are commonly controlled by proximate rather than ultimate considerations, can never be brought to favour the abandonment of the tariff. The sentiment against change is compact and crystallized, while that of the community at large, the chief beneficiaries of freedom of commerce, is unorganized and of a general character, and it goes without saying that when a definite commercial interest comes into controversy with a general sociologic interest the former and not the latter will control legislation.

Should it be urged that the above argument is not peculiar to protective legislation, since every tax law enters as a factor into the conditions under which industry is carried on, it must be admitted that there is some truth in the statement. Protective tariff legislation, however, differs from ordinary revenue laws in two particulars.

In the first place, so far as the laws of taxation call for a visible payment assessed to persons or imposed on property no commercial or class interest can be urged against the abandonment of such legislation. So far, on the other hand, as revenue laws enter into the price of commodities, in such a manner as to confine the purchaser of goods to the home market, they create within the country conditions of manufacture different from those that exist in foreign or competing countries, and the modification of such laws comes to be a matter of great concern to the home manufacturer. In the second place, a revenue law enacted and administered under the guidance of the revenue principle carries with it a sure test of its own efficiency, while a system of taxation in which the financial principle is subordinated to industrial ends is, in a large measure, superior to the tech-

nical criticisms of the financier. It thus appears that there are special reasons why customs duties framed to meet the requirements of industrial protection are more persistent than ordinary tax laws.

Another point in which the experience of nations differs from the theory of protection is that the policy is extended to all industries instead of being confined to the manufacturing industry. In the United States, for example, where the agricultural industry furnishes the chief portion of the nation's exports, the protective policy has been extended to agricultural products. A moment's consideration must make it clear that an industry which furnishes a large surplus for export cannot be assisted by imposing limitations upon the importation of such goods as it produces; and the fact that such goods are included in the list of protected commodities is due to the desire on the part of those interested in protection to say that this legislation is not class legislation. Where government is not dependent upon popular vote, or where a single interest is represented in the law-making body, protection need not stultify itself by advocating an "all-round" protection.

The fact that the rates charged under a protective tariff rise rather than fall from year to year, and that an industrial community fostered by protection is marked by instability, has the same explanation. It is the natural desire of all business men to reap as high a rate of profit as possible from the industry in which they are engaged. In so far, however, as the conditions of commercial competition are maintained it is not possible for one industry to enjoy for any considerable length of time a profit greater than another industry. The argument which asserts that competition within a country will bring down the rate of profit in protected industries to the general average in the community is sound in theory, and the result might be realized in practice were it not for constant changes in tariff laws. The protected manufacturer finds in every modification of the tariff an opportunity for unusual profit during the time that industry is adjusting itself to the new tariff conditions, and it is consequently to his advantage that customs duties should not be stable. It is the constant change that is the source of unusual profit to protected industries, and the financier must recognise that his

revenue system cannot be stable so long as the revenue principle is subordinated to the protective principle in the framing of customs duties. Instability of industrial conditions must be accepted as one of the inevitable results of any system of protective duties

It would be possible to refer to many other results of the levy and administration of taxes, but those to which attention has been called are perhaps all that are essential to an appreciation of a sound revenue system.

CHAPTER V.

ADMINISTRATIVE CONSIDERATION OF TAXES.

SHALL ALL REVENUE BE SECURED BY A SINGLE TAX?

- (1) The Single Income or Property Tax.
- (2) The Single Excise System.
- (3) The Single Land Tax.

HOW MAY THE RATE OF TAXATION BE DETERMINED?

- (1) The Rate for Direct Taxes
- (2) The Rate for Indirect Taxes.
 - (a) The Financial Interest.
 - (b) The Sociologic Interest.
 - (c) The Administrative Interest.

ADMINISTRATIVE QUESTIONS RESPECTING THE GENERAL PROPERTY TAX.

- (1) Inequalities between Persons
- (2) Inequalities between Real and Personal Property.
- (3) Inequalities between the Several Grades of Government.

ADMINISTRATIVE QUESTIONS RESPECTING THE CORPORATION TAX.

- (1) Selection of Industries to be Taxed.
- (2) The Proper Basis of Assessment.
 - (a) Property the Basis of Assessment.
 - (b) Volume of Business the Basis of Assessment.
 - (c) Earnings the Basis of Assessment.
 - (d) Special Cases of Assessment.

ADMINISTRATIVE QUESTIONS RESPECTING CUSTOMS AND EXCISE DUTIES.

- (1) Choice of Articles for Import Duties
- (2) Choice of Articles for Excise Duties.

ADMINISTRATIVE QUESTIONS RESPECTING INCOME TAXES.

THE purpose of the present chapter is to discuss certain questions which arise in the framing of tax laws, the discussion being regarded primarily from the point of view of administration.

67. Shall All Revenue be Secured by a Single Tax?—Any scheme of taxation by which simplicity in fact as well as in

name may be secured would receive the immediate and universal approval of financiers, and it is largely as a means of attaining simplicity that certain writers have been led to approve the idea of single taxation. The plan which commends itself to the treatise consists in a careful classification and judicious selection of sources of revenue. As a means of strengthening this conclusion we shall pass in rapid review a few of the more prominent schemes of single taxation that have from time to time arrested public attention.

(1) *THE SINGLE INCOME OR PROPERTY TAX.*—While the abolition of all taxes except those imposed on incomes or property has never been seriously proposed as a measure for immediate adoption, there is scarcely a general treatise upon finance that does not give a more or less direct approval to the thought that the simplest and fairest tax is the one that accepts personal income as the basis of contribution. Whether the authors of these treatises intend it or not, the impression is left that as the revenue system approaches the taxation of incomes it attains its ideal perfection.

We need not arrest our investigation with a consideration of the difficulties that lie in the way of the assessment, levy, and collection of taxes on personal incomes, for the argument goes astray before it reaches this point. It is manifest, if any one thing, or element, or quality is to be made the basis of the levy of taxes, it must possess homogeneity, not alone from the industrial point of view, but from the social and political points of view as well. It must bear the same import to all citizens, and not change its character, either for the citizen or the State, with changes in its quantity or its use. This is not true of personal incomes. Whether regarded as possessions or as potential expenditure, incomes change their quality with their amount, and the social results of their expenditure vary with the objects to which expenditure is assigned. All this is familiar to the student of the most recently developed economic theory, which aims to disclose the ministry of wealth and to re-analyze the principles of production and exchanges in the light of the economy of consumption. Assuming the analysis thus suggested to be sound, it is evident that while the single income tax might contribute simplicity to the revenue system so far as the object of taxation is concerned, yet it would nevertheless bring the system again into

confusion on account of the classification of incomes, and the great variety of ratings that would be necessary to attain justice, either from the point of view of the relative payment of individuals or when considered as a permanent feature in the social structure. But this line of reasoning has already received adequate attention*. The considerations, moreover, upon which this general conclusion rests are equally pertinent to all of that large number of propositions for single taxation which attach themselves to some peculiar feature of property, and on this account their special consideration may be omitted.

(2) THE SINGLE EXCISE TAX.—An excise tax, as that phrase was used before differentiated from import duties, implies an assessment levied on the producer or the dealer in the expectation that its payment will be transferred to consumers in proportion to their respective expenditures. The propriety of calling an excise tax a single tax rests upon the assumption that the basis of its levy is the domestic budget. It is a single tax in the sense that it is imposed on family or personal expenditures.

The enthusiasm with which excise taxes were regarded by the eighteenth century was due to the thought that none could avoid them. Consumption being the only fact of life common to all citizens, a tax on consumption was accepted as a means of securing universality of contributions for the support of the State. It was a part of the doctrine of eighteenth-century liberalism to approve the excise taxes, and of conservatism to oppose them; for the liberals in this controversy were the middle classes, on whom public burdens rested after the decay of feudalism, while the conservatives were the nobility and clergy, who, according to common practice, were exempt from many of the pecuniary burdens imposed by the State. But it cannot be denied that the simplicity of the excise tax, as it was at first conceived, was greatly in its favour, and that this argument, common to all schemes of single taxation, could be urged, so far as formal logic was concerned, in favour of an exclusive and comprehensive excise tax. It is not strange, therefore, that "the excise taxes of the seventeenth and eighteenth centuries were regarded by financiers as the principal form of taxation destined, if not to replace all other kinds of im-

* *Vide* Chapters II and III of this Book.

post, at least to hold the principal position in the fiscal system" *

No extended argument is needed to show wherein this theory erred. An excise system is a single-tax system in name only, for, although it accepts expenditure as the basis of payment, it does not bear a common significance to all classes in the community. Expenditures develop with expanding income. They follow certain more or less rigid psychological and social laws. Commodities vary in their economic character according to the grade or persistence of the want they are designed to satisfy. As the sense of equity in taxation grew, being one phase of the growth of democratic sentiment, these psychologic differences in the varying sorts of expenditure led to the classification of commodities, and to the assignment of different rates of taxation to each class; that is to say, the demand for equity in the administration of excise taxes led to the adoption of measures which destroyed the simplicity of the system, and in this manner broke the force of one of the arguments by which the theory of a single-tax excise was supported.

It is not necessary to rely for analysis upon this conclusion. In no country in the world have excise taxes been used as a system of general taxation without drifting into a confusion of imposts, and calling sooner or later for radical reforms. In 1672 William Temple declared of the Holland system of excise taxes that any one who ate a dish of fish in Holland paid thirty different taxes when settling the bill. In the year 1817 there were in force in Prussia fifty-seven tolls and excise tariffs comprising 2775 articles †. The financial reform which took place in England in the nineteenth century resulted in the abandonment of the general import duties, these being regarded as excise duties within the meaning of this discussion, and the substitution for them of an import duty on a few carefully selected commodities. Thus the history of the excise taxes, where they have been tried, shows that they cannot retain their simplicity and at the same time retain their character of a general excise system. The demand for justice of payment as between citizens must destroy inevitably the simplicity of the tax in its original form.

* Bastable, *Public Finance*, p. 472.

† Cohn, *The Science of Finance*, p. 406.

There is another reason why "taxes on consumption" cannot be accepted as an adequate basis for a fiscal system. They are not universal in proportion to income, for their payment may be evaded by a penurious system of living. This consideration was regarded lightly so long as the classical doctrine of capital building retained its influence. According to this doctrine capital was built out of personal savings, and, should one evade payment for the support of the State by curtailing expenditures below what is sociologically warranted by his income, he must nevertheless of necessity serve the public, because what he saved would be converted into capital for the advantage of the public. This is no place to consider the economic theory of capital, but, to state the situation in mild language, the doctrine that the industrial development of a nation is dependent upon the personal savings from private incomes has been surrounded by so many modifications as to render it of comparatively little importance in the discussion of any industrial or financial question.

For two reasons, therefore, it is not possible to consider excise taxes as a satisfactory basis of the system of single taxation. Its simplicity is apparent rather than real, and it does not guarantee universal contribution from those who pay taxes in proportion to ability to pay.

(3) THE SINGLE LAND TAX.—The most persistent of the schemes for single taxation is the one which accepts land for its basis, a fact which is doubtless explained by the manifest relation which land bears to industry in that it is the source of material products. During the past one hundred and fifty years the theory of the single land tax has secured for itself two expressions—the one that of the Physiocrats, the other that of the modern "Single Taxer." The fundamental idea is the same for both of these programmes, although their expression differs according to the respective economic theories with which they are in harmony. They both address themselves to that fund of value which accrues to the owner of the soil, and which is peculiar in this, that any payment made out of it cannot react upon other industries. This fund is now called rent. It was called by the Physiocrats a net product.

According to the Physiocrats all industries and occu-

pations except agriculture were "sterile," that is to say, they created no value, inasmuch as the value of their products was equal to the value of the raw material used, and of the commodities consumed by the labour, while carrying on production. It was not claimed that manufactures, commerce, government, and the like were useless, but that they produced nothing in excess of what they consumed. When one calls to mind the confusion resulting from the practice of indirect taxation as it existed in Europe in the seventeenth and eighteenth centuries he can readily understand how the Physiocrats came to believe that whatever entered as an element of cost in the manufacturing processes, whether it be material, wages, or taxes, must come out of the net product of agriculture; and it is easy to appreciate with what enthusiasm the eighteenth-century student adopted the proposal that the government should take all that it needs for its support at the beginning and relieve manufactures and commerce from all subsequent demands. The source of payment he assumed to be the same in either case, and the substitution of a single land tax for excise duties appealed to him on account of its simplicity and its certainty.

The Physiocratic scheme of taxation lost its control over the imaginations of men when it became clear that the net product which accrues in connection with agriculture is not due to the generosity of nature, but to the unequal manner in which nature distributes facilities for production. It is not a surplus value to agriculture as such, but a differential profit which accrues to the more fortunate landowners. It is, in short, rent, as defined by Ricardo. It was the peculiar service of Adam Smith to show that all useful labour creates value, and therefore that all useful industries are productive, and not sterile. This of course took from the Physiocratic scheme the premise upon which the justice of the single land tax rested.

The modern advocate of the single land tax recognises the Ricardian doctrine of rent and makes it the basis of all his reasoning. His justification for the taxation of land to its full rental value is that this value does not result from anything which the owner has done, but from the growth of society. The tax appears to be just, since it enables society, through the government, to take for its own purpose the

value which it itself has created. The error in this line of reasoning lies in the assumption that the influence of social evolution upon values is confined to the values of real estate. The secret of wealth in the nineteenth century is organization and combination, and there is scarcely an industry which, to some degree at least, as compared with previous years of its existence, has not experienced an accumulation of values due to general industrial attainments and higher ideals of living. The mistake of the modern single-tax advocate is in kind, although not in form, the same as that of the Physiocrat. He confines the application of an industrial principle to a single form of industry. While it is doubtless true that the influence of social development upon the increase and decrease in land values may be more clearly traced than in other property, it is a mistake to assert that this influence is confined to landed property. It thus becomes evident that the single land tax cannot be a just tax as between the owners of real estate, who, it is admitted, are in the enjoyment of a differential profit, and the proprietors of other forms of industrial property which also give rise to a differential profit. The inability of the tax on land to its full rental value to provide "free land" has already been referred to*. The difficulties incident to administration also have been cursorily discussed†. If, now, to these conclusions be added the conclusion that the tax proposed does not recognise all forms of fortuitous or socially produced income, we are warranted in dismissing this programme finally from our consideration‡.

Professor Cohn § in his presentation of this subject submits five reasons why a State cannot base its revenue system upon any single tax. Two of these reasons are worthy of repetition. In the first place, he states that the "payment of taxes rests, as we are well aware, on various principles of

* *Vide* § 66, (2).

† *Vide* § 41, (2).

‡ It is probable, when the lego-historic significance of corporations and the industrial character of large industries come to be fully apprehended, that some keen thinker of narrow horizon will discover that corporation taxes should be used to the exclusion of all other forms of impost but until that time arrives it does not seem necessary to show why such a suggestion would be no more tenable than any of the other schemes of single taxation.

§ Cohn, *The Science of Finance*, p. 377.

equity, which cannot all be satisfied by the single tax." In explanation of this he calls attention to payments for the support of general governmental functions, such as school taxes, police service, and the like, payments which are particular in their character. It does not lie in this treatise to press this distinction as far as does Professor Cohn, but when one holds in mind the evolution of society and the development of governmental functions he is obliged to concede that a revenue system adequate to one stage of development or to one phase of public activity may not be pertinent to another. A multiple system of taxation is necessary to insure an easy evolution in the fiscal system pertinent to a complex society.

Another consideration urged by Professor Cohn against a single tax is found in the fact that "the organization of a commonwealth under a system of larger and smaller civil divisions, especially in a federal State, gives rise to peculiar fiscal conditions such as do not admit of our placing at the disposal of each of these civil divisions a single form of taxation which is to be used by all in common." The student will appreciate the significance of this suggestion when in the subsequent chapter it is endeavoured to frame a revenue system adequate to the needs of the Federal American State.

Our conclusion, then, is as follows: While simplicity in taxation is conceived to be of paramount importance, no scheme of single taxation has yet been devised for attaining this end without sacrificing the principle of justice or, in its attempt to realize justice, drifting into inextricable confusion; moreover, an appreciation of the complex relations of the industrial organization, of the many forms of governmental service, and of the several grades of governments which together make up the State seems to warrant the assertion that no single tax is conceivable which can satisfy the demands of a sound revenue system. As Professor Bastable remarks: "The defects of the opposed systems of single and of multiple taxation tend to countenance what has been called 'plural taxation,' in which the revenue is not, on the one hand collected by a single form of duty, nor on the other divided into a great number of trifling charges." *

* Bastable, *Public Finance*, p. 323.

68. How May the Tax Rate be Determined?—No part of the revenue system comes so readily under the influence of practical considerations as the adjustment of the rate of taxation to the object taxed. Rate-making is at best a compromise of interests. It is an exponent of policy, and for this reason among others it is evident that no hard and fast rules can be laid down. The limit of scientific procedure in this direction is found in the presentation of those considerations by which the adjustment of rates may be properly influenced. Three general cases present themselves: first, that of a direct tax to the individual when property or income is made the basis of payment, second, that of an indirect tax to the individual when the payment of the tax is carried to the consumer is the price of a service or commodity; third, that of a direct tax to a corporation or business which reaches the individual in the form of reduced dividends to shareholders or through readjustments in the terms of contracts. The first and second of these cases will now be discussed, the third seems to unfold itself more naturally in connection with the administrative questions suggested by corporation taxes.

(1) **THE RATE FOR DIRECT TAXES**—In case the tax under consideration is a direct tax, the quantity of the thing taxed, as well as the amount to be raised, having been determined, the adjustment of the rate is a very simple matter. The rate at which the tax settles will be the rate necessary to secure the money needed. The property tax as practised in this country serves well as an illustration. The assessor lists the property, the legislature votes the expenditure, and the rate is determined by computing what per cent the expenditure is of the value of the property listed. It is common for this aggregate rate to be made up of several special rates. The township, the county, the school, and the State tax is each determined by itself, and each assigned in turn to the property assessed. The rate of an income tax also is made in very much the same manner in those countries where the revenue from this tax is used to even up the discrepancy between ordinary revenue and ordinary expenditures, or to provide a fund for some unusual service. It thus appears that, in the case of direct taxes on known amounts, the determination of a rate presents no difficulties.

(2) **THE RATE FOR INDIRECT TAXES**—When, however,

indirect taxes, such as import duties, excise duties, or the taxation of a business that permits no differential profit, are under consideration, the question cannot be so easily disposed of. Such taxes enter as an element of cost into commodities or services, and on this account tend to disturb what would otherwise be the normal relation between supply and demand. Thus the probable effect of taxes at the several rates proposed must be carefully considered and that rate chosen which will be the least deleterious or the most advantageous, all things taken into the account. Moreover, the sociologic significance of the commodity or business accepted as the basis of the tax must be permitted to influence the relative rates imposed. These suggestions will become definite if we, first, consider the rule for rate-making laid down by the financial interest; second, the modification of this rule in the interest of normal social development; and third, a further modification in the interest of effective administration.

(a) *The Financial Interest*—By the financial interest as the phrase is used in this connection is meant the desire to obtain adequate revenue in the easiest and surest manner. To this end the industries selected as the basis of taxation will be those which minister to the universal necessities of life, and the rate imposed will be considerably under what is technically known as the maximum revenue rate. Under such conditions there will be no considerable tendency for the tax to curtail consumption. Large amounts may be raised by virtue of the universality of the payment, and, what is also of importance, the rate chosen being below the maximum revenue rate, the amount of revenue will increase or decrease as the rate itself is raised or lowered. Thus elasticity of revenue, as well as certainty and ease of collection, will result when commodities taxed are the necessities of life, and when the rate imposed is less than the maximum revenue rate. Productivity is secured by the broad basis upon which taxes rest rather than upon the high rate at which they are operated.

It is common to say that the demand for those commodities which minister to the comforts and luxuries of life is more sensitive to price than the demand for the necessities of life. In so far as this is true the maximum revenue rate for the latter must be a lower per cent of the price which the consumer pays than of the former, from which it follows

that necessities may be taxed at a higher rate without diminishing the productivity of the impost than in the case of comforts and luxuries. Upon the basis of this assumption, and regarding the matter purely from the fiscal point of view, the rate of a tax which incorporates itself in the price of goods follows a descending scale as the goods in question ascend in the order of developed wants. The rate upon the necessities of life would be high, upon the comforts of life moderate, and upon the luxuries of life low.

This rule, however, overlooks one important fact of human nature. Even from a fiscal point of view its rigour must be somewhat modified. The classification of commodities into necessities, comforts, and luxuries has no very concise meaning for a society that is stratified along the lines of income and expenditure. Demand is a matter of habit, both hereditary and acquired. Each class in society, so far as classes depend on the money one can spend in living, feels its own needs to be imperative whatever they may be, and it is not universally true that a rise in price will act more quickly on demand in the case of goods adaptable to the higher rather than to the lower wants in the order of social development. Especially pertinent is this observation to the conditions as they present themselves in the United States, where the common experience of the large majority of the people is to live in the presence of assured necessities and under the influence of a constantly growing sense of social and æsthetic wants. Not uncommonly will it be the case that threatened deprivation of a commodity, the possession of which is the badge of social standing, will be felt more keenly, and lead to more strenuous effort, than the placing in jeopardy of some of the commonly accepted necessities of life. From this it becomes evident that the maximum revenue rate for intermediate commodities may approach that of the necessities of life.

In the case of luxuries, also, a possible exception to the above rule of rating presents itself. It is a commonplace of practical business that a high price for certain kinds of goods is a factor favourable to intensity of demand, and, in so far as this is the case, a tax which increases the price will not defeat itself by acting as a deterrent to purchasers. This truth is of relatively slight importance, however, in adjusting the rates of a general revenue system, because citizens who

enjoy an income sufficiently ample to warrant careless expenditures are relatively few, and no government could hope for any considerable income by imposing a high tax upon class luxuries. The rule of rating, therefore, as laid down by the financial interest, while it may indicate in a general way the curve of rates for goods designed to satisfy wants of different social grades, must, even in the interest of revenue, be applied under the direction of accumulated experience.

(b) *The Sociologic Interest* — But there are other considerations to be taken into the account. The sociologic results of taxation cannot be overlooked. In so far as price is a factor in determining the extent or the direction of purchase and consumption the tax, when of such a form as to be an element in price, becomes one of the conditions under which social development takes place. What grade, class, or quality of goods is it desirable that society should consume? What order in the development of consumption harmonizes with the rule of social progress? In what class is found the strength of the State, and how may the further extension of that class be fostered? These questions, and others like them, must be answered by the financier before he can adjust the rate of taxation to the requirements of a satisfactory revenue system. The reasoning upon this point has been adequately set forth, and it only remains to say that what is termed the sociologic interest presents a rule for adjusting rates wholly at variance with the rule laid down by the purely fiscal interest. The sociologic rule for ratings is as follows: the rate of taxation should increase as the goods taxed rise in the scale of social use. The necessities of life should be freed from taxation or taxed at a relatively low rate; the intermediate goods should be taxed at a higher though not an excessive rate; while the luxuries should be imposed with the full maximum revenue rate. If it be desirable for sociologic reasons to discourage the consumption of goods regarded as pernicious, such goods should be imposed with a tax in excess of the maximum revenue rate. Such at least is the contribution of the sociologic interest to the question of rate-making.

(c) *The Administrative Interest* — It would be a mistake to settle any question of taxation without consulting the administrative interest, and in no case is this remark more

pertinent than when the question of rate-making is under consideration. The smuggler and the illicit manufacturer are ever present, and their influence in preventing the normal working of an import tax or of a system of excise duties cannot be overlooked. It would be useless to impose a high rate should the result be to stimulate unduly the activity of those who make their livelihood by evading the tax laws.

Two ways are known for the discouragement of smuggling and illicit manufacture. The one calls for a strong body of police and an efficient revenue detective agency, the other aims to remove the motive for illegal traffic by reducing the tax so that the profit which may be gained by smuggling and illicit manufacture will not compensate for the danger incurred. This means, among other things, that the practical limit to the rate at which a commodity may be taxed depends in large measure upon the ease or difficulty with which the commodity can be smuggled or illicitly manufactured. In general, the goods that invite the attention of smugglers are those which carry a high value in small bulk, that is to say, goods which minister to the wants of the more wealthy classes in the community. It thus appears that while the financial and the sociologic interest would lay a high rate upon class luxuries, the administrative interest precludes the feasibility of such a rate. Diamonds, for example, will be worn regardless of cost, and on this account might be imposed with a high duty; the sociologist, also, would permit them to be listed among highly taxed commodities. But it is evident that the tax might easily be placed so high as to defeat revenue. The practical limit of a rate is the ability of the administration to collect it.

From the above considerations it appears that the adjustment of a rate is not a simple matter. It cannot be accomplished by arbitrary rule, and all that can be done in a scientific treatise is to state clearly the interests involved and to leave the application of the principles discovered to the practical judgment of the body whose duty it is to frame tax laws. The matter is very largely one of social psychology, and more light will be thrown upon the subject by the lamp of experience than by the theories of writers. Financial statistics are of the greatest importance to one who would determine the proper rate of taxation. Thus far in the history of

most peoples fiscal exigencies have been so imperative as to place the adjustment of rates almost exclusively under the guidance of the fiscal and administrative interests. Not only have those duties been selected for taxation which minister to the necessities and comforts of the great body of the people, but the rates selected have commonly been those capable of producing the largest amount of net revenue. It may be expected, however, as the social conscience becomes more defined that the sociologic interest will exert a relatively greater influence upon the adjustment of rates.

Other questions there are of a general character, such as the comparison of local and national taxes, the use to be made of specific and *ad valorem* duties, the means of avoiding double taxation, and the like, that might be made the subject of independent analysis; but, partly on account of the limited space at the disposal of this treatise, and partly because the practical character of such questions permits one to judge with greater confidence respecting them when presented in connection with some definite proposal, their separate consideration is not here attempted. Better results may be expected from an inquiry into the various forms in which tax laws may be drawn, and from an investigation into the possibilities and limitations of those methods of raising derivative revenue which the analysis of the nature of taxes has left at the disposal of the financier. Following out this suggestion we shall now turn our attention to a consideration of property taxes, corporation taxes, excise and customs duties, and income taxes, from the point of view of him who frames and administers tax laws. A theoretic analysis of these taxes has already been presented, we shall now undertake their analysis as projects of law.

69. Administrative Questions Respecting the General Property Tax.—It will be remembered that the general property tax accepts value of all property, irrespective of its industrial character or of the use to which it is put, as the basis of the universal tax levy. The error involved in this theory, as was pointed out, is that value is not a homogeneous quality of things, and that any system of taxation which assumes it to be such must work unjustly as between the holders of different sorts of property. This is, however, scarcely adequate as a final argument against the property tax, for

if no other difficulties present themselves it might be possible to attain substantial justice by classifying property according to its economic character, and by assigning an appropriate rate to each class of property. It is true this would destroy the formal simplicity of the scheme and introduce complications that would render the system more difficult of administration than it is at present; but it would satisfy the objection of the theorist. It seems necessary, therefore, before concluding that the general property tax should be abandoned or radically modified, that we inquire respecting the manner in which this tax works in order to discover if the difficulties by which its administration is surrounded are so serious as to render futile any readjustment in its form that might be undertaken.

The making of a tax bill is a very simple affair so far as method of procedure is concerned. In a State like Michigan, for example, whose local government is a compromise between the county and township system of organization, the assessment, levy, and collection of taxes are intrusted to township officers. It is the duty of the assessor to list the property in the township and to assign to it a valuation for the purpose of taxation. The name of each citizen who pays taxes is entered upon the assessor's books, and against his name is set down the amount of his property, classified according to the requirements of the law. The assessment roll made up in this manner is accepted as the basis for the levy of township taxes. The county obtains its list for county taxes by combining the assessment rolls of the several township officers, while the State levies its taxes upon the combined valuation of the counties. In the bill presented to the taxpayer it is common to state separately the rate imposed for each of the grades of government or special objects supported by the general property tax, and what is known as the rate of local taxation in the United States is the sum of these separate assessments less the amount collected for State purposes. The collection of taxes follows in general the same theory. The local officer, commonly the treasurer of the township or of the county, according as the township or the county is the unit of local administration, receives the taxes and pays over in lump sum the amounts due the other grades of government in proportion to the percentages expressed in the tax bill. This, however, is a purely

ministerial function, and being the occasion of no difficulty in the administration of the law, will not receive further consideration

The evils of the general property tax centre in the task of assessment. While the great mass of property was in the form of real estate, and while such personal property as existed was simple in its industrial character, the general property tax worked fairly well. Under such conditions it was possible for the assessor to list fully and assess fairly the property of citizens. But since the development of corporations has changed the character of industrial property, giving it a form that can easily be hidden from the eye of the assessor, and since credit relations have developed to such an extent that double taxation must inevitably follow the listing of the property of all citizens, the task of the assessor has become a very difficult one. Not only does he find it impossible to discover personal property of those who refuse to make reply or who are guilty of false returns, but the dishonest citizen, taking advantage of those provisions of the tax laws designed to avoid double taxation, is able so to locate his property as to evade assessment.

To speak definitely upon this point, three difficulties present themselves in the administration of the general property tax

First This tax works unequally and unjustly as between citizens of the same town

Second It works unequally and unjustly as between real estate and personal property

Third It works unequally and unjustly as between the townships, whose property is used as the basis of county taxation, and the counties, whose property is used as the basis of State taxation

(1) *INEQUALITIES BETWEEN PERSONS*—The inequality of the general property tax as between citizens of the same town arises on account of the fact that the assessor must, to some extent, rely upon the declaration of property by citizens for the purpose of taxation. This, indeed, is the theory upon which the administration of this tax rests. The law commonly states that each citizen shall return, either in writing or verbally in response to questions asked, a list of all property belonging to him that is taxable under the law, and

in some States he is obliged to take his oath as to the accuracy of his statement. The assessor, it is true, is at liberty to revise the statement thus made in case he believe it to be a false statement, and the citizen, also, has the right of appeal to a properly authorized board; but after all is said and done the assessments of specific properties will remain proportionally to each other as they were originally handed in.

As an illustration of the nature of the oath attached to the list of questions which the taxpayer is called upon to answer the following, used in the State of Georgia, is submitted. "I do solemnly swear that I have carefully read [or have heard read] and have duly considered the questions propounded in the foregoing tax list, and that the value placed by me on the property returned, as shown by said list, is at the true market value thereof, and I further swear that I returned, for the purpose of being taxed thereon, every species of property that I own in my own right, or have control of, either as agent, executor, administrator, or otherwise, and that, in making said return for the purpose of being taxed thereon, I have not attempted, by transferring my property, or by any other means sought, to evade the laws governing taxation in this State. I do further swear that in making said return I have done so by estimating the true worth and value of every species of property contained therein" *

As illustrating the extensive powers which it seems necessary to repose in the hands of public officers for the purpose of administering the general property tax reference may be made to the taxing laws of the State of Ohio. In this State "parties may be summoned, questioned under oath, and if any person fails to appear, or appearing, refuses to testify, 'he shall be subject to like proceedings and penalties for contempt as witnesses in actions pending in the Probate Court' The costs and expenses must be paid by the person whose property is under examination, if he has made a false statement to escape the payment of taxes in whole or in part, but if the statement of the person is correct, and no intention to evade the payment of taxes shall be evident, the costs and expenses must be paid by the county

"If a person refuse to list or swear his property to the

* Ely, *Taxation in American States and Cities*, p. 162.

assessor, the auditor shall add fifty per cent to the amount returned or ascertained, and the amount thus increased shall be the basis of taxation."*

These illustrations are typical and indicate the process which, under one form or another, must be relied upon for the administration of the general property tax. Dr. Ely is right when he says. "The law affords every facility to the officers intrusted with the administration of the tax laws for the ascertainment of property. Indeed, it is hard to see how law could go further"† But, notwithstanding these provisions for the execution of the law, it is the universal experience of the American States that assessments are unequal and unjust as between citizens. An oath is worth no more than an affirmation, an affirmation is at last analysis self-assessment. It results, therefore, that the amount of property handed in, as also the valuation of visible property, is determined, even by honest citizens, by the amount which they consider to be their just relative payment for the support of the State; while the amount handed in by dishonest citizens is the smallest amount which they believe they can induce the assessor to accept. No scheme could be devised for fostering dishonesty like this one of self-assessment, and it should be final against the continuance of the general property tax that it must rely upon self-assessment. It might properly be characterized as a taxing system degressive in its assessments in proportion to dishonesty. They who are honest are taxed upon a large proportion of their property, while the dishonest are enabled to evade the performance of their full duty to the State. The report of the Tax Commission of Ohio does not present the case too strongly when it says that the general property tax results in debauching the moral sense and is a school of perjury, imposing burdens on the man who is scrupulously honest.

(2) INEQUALITIES BETWEEN REAL AND PERSONAL PROPERTY—It is evident that the task of assessing property for the purpose of taxation may be more fully and equitably accomplished for real estate than for personal property, a fact which shows that the general property tax, if used to the exclusion of all other forms of taxation, will be guilty of

* Ely, *Taxation in American States and Cities*, p. 155.

† *Ibid.*, p. 154.

demanding relatively greater payments from those engaged in agriculture than from those engaged in other callings and pursuits. It is believed that this fact, when appreciated, will cause the abandonment of radical revision of the general property tax scheme. "Personal property nowhere bears its just proportion of the burdens, and it is precisely in those localities where its extent and importance are the greatest that its assessment is the least. The taxation of personal property is in inverse ratio to its quantity, the more it increases the less it pays." So remarkable a generalization calls for statistical support, and there are here inserted a few facts collected by Professor Seligman, from whom the generalization is quoted:

"The tenth census of the United States asserts that from 1860 to 1880 the assessed valuation of real estate increased from 6973 millions of dollars to 13,036 millions, while that of personal property decreased from 5111 to 3866 millions. In 1890 the assessed valuation of real estate had grown to 18,956, while that of personal property was 6516 millions,—less than the figures of thirty years before. In California personal property was assessed in 1872 at 220 millions of dollars, in 1880 at 174 millions, and in 1887 at 164 millions,—a net decrease in fifteen years of 56 millions. Real estate increased during the same period from 417 to 791 millions. Personal property paid 17.31 per cent, real estate 82.69 per cent of the taxes. By 1893, although the assessed value of real estate was 1000 millions, that of personalty was only 173 millions. In Illinois in 1882 personal property paid 22.01 per cent of the taxes, in 1894 only 17.26 per cent. In Cook County (including Chicago), personal property paid only 14 per cent; in Kankakee County only 11 per cent. In Iowa, while the real estate valuation in 1893 increased over that of the preceding year by 32 million dollars, the assessed valuation of personal property actually decreased. In New York the figures are as follows:

| | Real Estate | Personal Property. |
|----------------|----------------|--------------------|
| 1843..... | \$ 476,999,000 | \$118,602,000 |
| 1859..... | 1,097,564,000 | 307,349,000 |
| 1871..... | 1,599,930,000 | 452,607,000 |
| 1878 | 2,373,418,000 | 364,960,000 |
| 1888 | 3,122,588,000 | 346,611,000 |
| 1893 | 3,626,645,000 | 411,413,000 |

"The proportion paid by personal property has decreased steadily almost every year, until according to the last figures it pays but 9.99 per cent of the State taxation, as against 90.01 per cent falling on real estate. In twenty-five years the valuation of real estate has increased \$2,000,000,000; that of personalty has diminished about \$40,000,000. In the District of Columbia the valuation was in 1878 realty 83 millions, personalty 17 millions, in 1894 realty had increased to 160 millions, personalty had decreased to 11 millions. In New Jersey, in 1887, in one township the real estate was assessed at \$272,232, the personal property at \$591, in another the figures were \$2,274,900 and \$47,150 respectively. In New York the personalty was returned in one town at \$5000, in the adjoining but no more prosperous town at \$700,000. Perhaps the most remarkable figures are found in the large cities. In Cincinnati the valuation in 1866 was: realty, \$66,454,602, personalty, \$67,218,101. In 1892 the realty had increased to \$144,208,810, the personalty had decreased to \$44,735,670. In Monroe County, New York, in which the city of Rochester is situated, the realty was assessed in 1892 at \$132,202,478, the personalty at \$8,408,803. Finally, in the city of Brooklyn in 1893 real estate was assessed at \$486,497,186, while personalty was valued at \$19,123,170. Personal property, in other words, paid a little more than *three per cent* of the whole tax on property. In 1895 proportion fell still lower,—to *one and twenty-three hundredths per cent*" *

These statements are most remarkable and must carry with them the conviction that the general property tax fails in the first step of its administration, namely, in a just assessment of the property of citizens.

In the Eleventh Census of the United States is found a graphic statement of the assessed value of real and personal property for each of the States,† and as it would be impossible to present the argument against the general property tax more persuasively, it is here inserted. The diagram explains itself.

* Seligman, *Essays in Taxation*. Chapter on *The General Property Tax*, pp. 27-29.

† Eleventh Census, *Wealth, Debt, and Taxation*, Part II, p. 60.

tion, which from its nature must have a legal situs and maintain a current record of its property and earnings. The idea seems to be that the government should take its share of the earnings of the industries in question at their source. It is believed this tendency rests upon a sound administrative theory, and if carried out to its logical conclusion, which is that personal property representing corporate industry should be exempt from the assessor's roll and the corporation itself relied upon for the payment of all just dues to the government, that the revenue system will gain in clearness, in equity, and in ease of administration. The corporation taxes should not be regarded as supplemental to the general property tax, but as a substitute for that portion of the tax which addresses itself to the class of personal property referred to.

Admitting for a moment that a properly drawn corporation tax satisfies the problem of assessment for stocks and bonds, there remains one form of personal property which cannot be reached in this manner. Reference is here made to personal property in the form of notes, mortgages, and other credit instruments. No subject presents greater difficulties to the administrator than that phase of double taxation and tax evasion which arises on account of mortgages. The theory adopted by most laws is that a mortgage should be taxed to its full amount, and the property upon which the mortgage rests assessed at a value equal to its true value less the amount of the mortgage. Could this be done no injustice would arise, but it cannot be done. It is impossible for the assessor to discover mortgages. It is certain that they who hold them will not as a rule voluntarily declare them. On the other hand, it is equally certain that the owner of a piece of property on which the mortgage rests will declare the debt if by so doing his assessment can be reduced, and that, as a result, the State will be left with little or nothing upon which to levy taxes. It would be difficult to obtain a correct statement of property and mortgages were both mortgagor and mortgagee subjects of the same jurisdiction; it is impossible when they are citizens of different jurisdictions. Nothing would be easier than by means of fictitious mortgages between citizens of different States to enable all property, real as well as personal, to evade assessment.

Many remedial acts have been addressed to this difficulty

in the administration of the general property tax, but thus far they have all failed in their purpose. One of the most carefully devised of these laws was recently passed in the State of Michigan, by which it was required that the recorder of each county should furnish the recorder of every other county in the State a list of mortgages held upon lands by the residents of other counties. The immediate effect of this law was to disclose a large amount of personal property which had previously evaded taxation, but the ultimate effect was an exchange of mortgages by citizens of Michigan upon Michigan lands for mortgages held upon lands in other States.

Another experiment in the taxation of mortgages proved equally futile. It was provided that both the land and the mortgages should be formally taxed, but that, in case the owner of a mortgaged farm should pay the full amount of the tax imposed, he might use his tax receipt in payment of interest upon the mortgage to the amount that the mortgage itself was held for taxation. The immediate effect of this law was, first, that the rate of interest upon loans increased by one per cent; second, that the mortgage contract was so revised as to deny the borrower the liberty of presenting tax receipts in part payment of interest dues, and third, that the mortgages on Michigan farms were sent as rapidly as possible out of the State.

It is not necessary to consider at length the extended bibliography of this subject, or to pass in review all of the special laws designed to adjust equitably the burden of taxation between the borrower and the lender. An exhaustive investigation would bear out the conclusion that so long as each State administers its revenue system independently of other States it is impossible to secure just and comprehensive assessments of this class of personal property. Moreover, if the framer of a revenue system can convince himself that economic principles do act, and that the criticisms of a certain school of economists have not as yet caused the repeal of those fundamental laws of human conduct upon which the commercial world of voluntary association rests, it will not be necessary for him to consider seriously the question of taxing mortgages. A little more confidence in political economy, and a little less reliance upon minute legislation, would lead to better results. The distinction drawn in

the foregoing chapter between the payment of a tax and the shifting of commercial conditions incident to a tax was designed, on its practical side, to prepare the way for the remission of a large number of indirect taxes, for, in so far as competition can determine the price, whether of goods, of service, or of loanable capital, the "burden" of indirect taxes does tend to equalize itself throughout the community. That is to say, the relative conditions of men will be the same, so far as social service rendered and social benefits received are concerned, after the commercial shifting which follows a new tax has taken place as before the tax was imposed. A tax on mortgages, being a special tax upon one form of investment, is an indirect tax, and the result of a release of mortgages from taxation will be a lowering in the rate of interest on loanable capital. The man who buys property on credit (let us assume for purpose of illustration the case of a farm purchased with borrowed money) has no reason to complain if the capital which he borrows is not taxed to the holder of the instruments that represent the loan. It is true his property will be assessed to its full value regardless of the debt resting upon it, but the first effect of such an adjustment will be to reduce the price he must pay for his land; that is to say, the tax results in depressing the value of land by an amount equal to its capitalization. The second effect is that he will be obliged to pay less for the money borrowed with which to purchase the land. It is doubtless true that up to a certain point these two tendencies will counteract each other, for the lower the rate of interest the higher will be the valuation of land. But the balance will most certainly be to the advantage of the man who desires to buy land with borrowed capital; for the rate which fixes the price of land is the commercial or industrial rate, while the rate that must be paid for the money borrowed is the current rate on loanable capital. Not only is this latter lower in itself than the market rate on industrial capital, but it will be yet further depressed by the exemption of such capital from taxation. It is lack of confidence in commercial laws by which values are determined and to which contracts are adjusted that incites to a constant effort on the part of legislators to lay hold of loanable capital for the purpose of taxation. Experience shows this to be impossible and analysis

shows it to be unnecessary. There is no reason in the nature of the case, due allowance being made for the peculiar industrial qualities of government bonds, why the farmer should pay more for money than the government. The farmer's true interest lies in removing every element of uncertainty that surrounds a loan, and one of these is the threat of the law that mortgages should be taxed.

The conclusion from this somewhat extended discussion is that all personal property should be dropped from the assessment rolls—corporate property because it can be taxed to the corporation in a much more effective manner than to the individual, and credits because their exemption will tend to reduce the rate on loanable capital. The situation seems to be that personal property cannot be reached by the present system. Even the most severe laws are futile to secure its listing. It is, therefore, necessary that some radical changes be introduced into the system itself if the industry of agriculture is to be relieved from the relatively excessive burdens which it now bears.

(3) **INEQUALITIES BETWEEN THE SEVERAL GRADES OF GOVERNMENT**—Not only does the general property tax work injustice to the well-meaning citizen and to real property, it is also unequal in its assessments as between the several grades of government which together make up a larger taxing district. This is at least true in the United States as the tax is now administered. The assessors are commonly local officers dependent for their places upon the suffrage of those whose property they assess, and since these assessments are taken as the basis of county and State taxes, as well as of township taxes, a strong temptation is presented to each assessor to value the property in his township as low as possible in order that it may not be charged with an unduly large proportion of county and State taxes. Whether right or wrong need not here be discussed, but the fact is that each assessor regards himself as elected to represent the interests of his township as against the efforts of other townships to evade the payment of their just share of general taxes, and on this account he is tempted to undervalue the property of his district as an offset for what he imagines may be the undervaluation in other districts. The result is that no property is assessed at its true value. It must not be supposed that

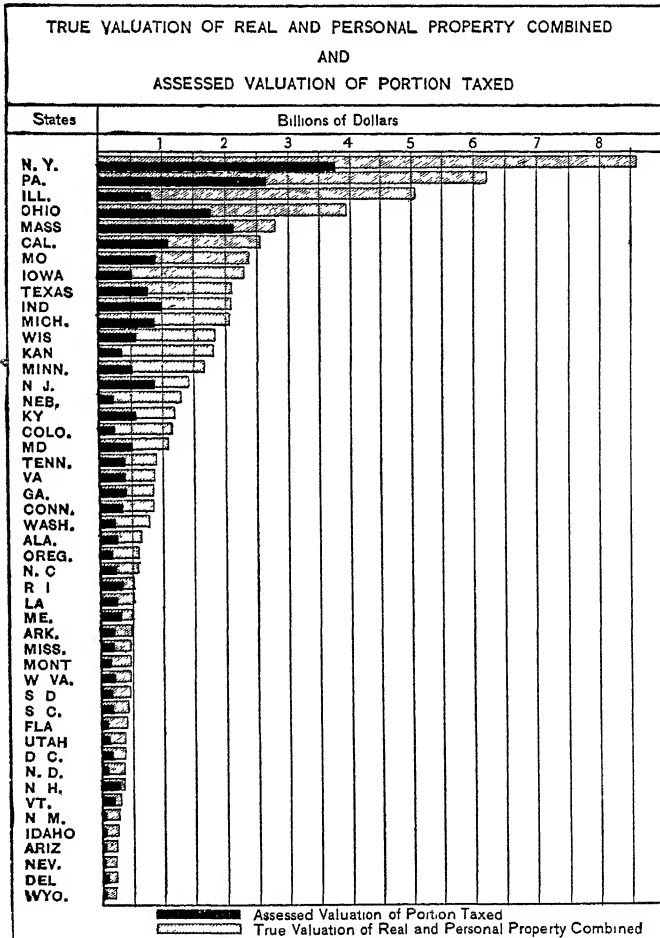
undervaluation is sanctioned by law. On the contrary, the laws of most of the States require an assessor to affirm on oath that he has listed all property at its fair selling value; but so great would be the injustice resulting from a strict compliance with the law on the part of one township while other townships permit property to be undervalued that it is impossible for the assessor to perform his duties as the law requires. He would not be justified in so doing and he surely would fail of reelection should he make the attempt.

The extent of undervaluation as estimated by the census authorities is shown in the graphic statement now presented.

The fact of undervaluation considered by itself is of relatively slight importance, since, for a given expenditure, its only result is to raise the rate at which property is taxed. It cannot affect the amount that must be paid. The evil of which complaint is justly made lies in the inequality of valuation of different townships when accepted as the basis of county and State taxes. There are several ways of overcoming this difficulty, the method adopted by most of the commonwealths being to establish boards of review, sometimes called boards of equalization, for adjusting the returns of local assessors. The county board equalizes the assessment between the townships, and the State board performs a corresponding service for the counties. This at best is a bungling piece of administrative machinery. The members of these boards of review have no reliable data at their command except such as are furnished by the local assessors themselves. How, then, can they revise the assessments with reason and judgment? As a matter of fact they commonly accept the lowest assessment as the basis of adjustment and scale down the valuation of other townships until the complaints of interested parties are somewhat mollified. It is thus evident that boards of equalization tend to intensify the undervaluation by the local assessors.

Another evil of the general property tax shows itself in connection with these boards. Inasmuch as city property is included along with country property in the same tax levy, it is not strange that the meetings of these boards of review should be characterized by a conflict of interests between the country and the town. Indeed; if one may judge from common report respecting their sessions, their chief interest

seems to be to shift the burden of taxation from country to city in those districts where rural population predominates, and from city to country where the voting strength lies with the municipalities. Administrative machinery could not be



adjusted with greater disregard to the way in which human nature works. The difficulty of the situation lies in the fact that local officers assess local property for State purposes. This is a fundamental error. Self-assessment, whether by

individuals for local purposes or by localities for State purposes, will ever prove a fruitful source of embarrassment

A second means by which the evils of undervaluation may be overcome is found in the suggestion that the assessors should be State officers. Being responsible to the State rather than to the localities, and dependent for their continuance in office upon the approval of the governor rather than upon the suffrage of their neighbours, the temptation to undervaluation would be in large measure removed. Of more importance, however, is the fact that the same rules for assessment would be followed throughout the State, and that cases which presented special difficulty being referred for decision to a central office would be decided according to some approved principle and in harmony with established practice. These are undoubtedly important considerations, but the method they suggest would lead to other and perhaps equally serious mischiefs. So far as assessment between citizens calls for a more or less intimate knowledge of local affairs, it is not likely that this could be secured in an officer appointed by the governor of the State. Nor can it be overlooked that the suggestion is not in harmony with the theory of local self-government, a fact which of itself may well cause one to hesitate before adopting the suggestion. The ever-present controversy between efficient administration as dependent upon centralization of political power and the conditions requisite for personal liberty and local autonomy is involved in the suggestion of State assessors, and the decision at which one arrives will depend largely upon the prejudices he entertains for or against local government. This treatise is obliged, in order to be consistent with the views already expressed upon analogous subjects, to search for some other means of relief than that of placing the assessment, levy, and collection of local taxes in the hands of State officers.

The only means of setting aside the difficulty under consideration consistent with generally accepted theories of government is found in the suggestion that the several grades of government be separated for the purpose of taxation, and that each grade be assigned a source of revenue peculiarly, if not exclusively, its own. Assuming such a change to be feasible, there would be no need of boards of equalization in order to equalize payments, for variations in the basis of

assessments could be the cause of no injustice. One county might estimate its property at forty per cent and another at eighty per cent of its true selling value, and the only result would be that the rate of taxation would be twice as high in the former as in the latter case. The suggestion thus presented is believed to be a most fruitful one for the reform of the American taxing system. For the present, however, it is sufficient to observe that the proposal is adequate to overcome the evils of unequal valuation in localities, while at the same time it regards all the rights of local administration.

Our conclusions from this practical consideration of the general property tax are two and as follows.

First The general property tax should be confined to the taxation of visible property, that is to say, of real estate.

Second The principle of segregation of revenue sources should be applied within the boundaries of the States.

70. Administrative Questions Respecting the Corporation Tax.—Four questions present themselves to the financier who designs establishing a system of corporation taxes. The first pertains to the proper selection of industries, the second to the proper basis of assessment, the third to the adjustment of the rate of taxation, and the fourth to the political conditions and interstate relations under which the tax is imposed. In the discussion of these cases familiarity with the historical significance and with the social and financial necessity of corporation taxes is assumed.

(1) **SELECTION OF INDUSTRIES TO BE TAXED**—Had it been possible to direct the organization of industries during the last fifty years with a view to the taxation of corporations, the task of the financier would now be greatly relieved. For reasons that need not here be discussed many industries are organized upon the corporate basis which, so far as their economic character is concerned, or their relation to public or *quasi*-public interests, might just as well have been carried on upon the basis of partnerships or joint-stock associations. It would be a mistake to include all corporations within the scope of the corporation tax, and the legislator is obliged to rely for the purpose of selection upon an economic analysis of industries, and to set aside for special taxation those industries only which are monopolistic in their character or

which for some other reason bear a public or *quasi*-public character * The reason for this is clear. All industries subject to the control of competition, whether organized as corporations or not, possess the same industrial character. The value of an investment in them will bear some relation to the cost of creating the plant, the quotations upon stocks and liabilities will gravitate toward the earning capacity of the enterprise, the rate of profit will be the ordinary rate of profit, and the income to the proprietors will measure with some degree of fairness the social value of their services. Moreover, the reaction of a general tax upon sales will be the same for the incorporated industry as for an industry of the same class organized as a partnership, and the special tax imposed upon them would work like any ordinary indirect tax. While, therefore, we speak of special corporation taxes, it must be understood that these are special taxes upon industries selected because of their peculiar industrial and social character. There are many taxes levied on corporations which are not, in the technical meaning of the phrase, corporation taxes †

Most prominent among the industries selected for special taxation is the railway industry, Rhode Island being the only State in the United States which treats railway property the same as other property. The explanation of this is simple. The railway industry was the first to show the peculiar evils of

* The student will observe that an economic analysis upon which the selection of industries for special assessment rests is, in its essential character, the same as that already presented in the chapter upon "Revenue from Public Industries." The truth is that the corporation tax and the public ownership of industries are two conflicting methods of solving the same problem, and the employment of the one method in any particular case excludes the use of the other.

† The subject thus touched upon is a broad and a comprehensive one. It is the conviction of the author that the corporation laws of the States must be revised so as to grant the privilege of incorporation to those industries only which are subject to the law of increasing returns or which render some peculiar public service. The seventeenth-century theory of the corporation must be revived and applied to modern conditions, provided it is the determination of legislators to direct the tendencies toward centralization of industrial power to the best service of the people and of the State. The conclusion respecting taxes in harmony with this idea is that those industries only which, under a just *regime* of industrial association might claim the privilege of incorporation, are to be regarded as fit objects of special taxation.

corporate organization, and on this account arrested the attention of tax reformers. From the administrative point of view the ease with which stocks are bought and sold renders it impossible for the assessor to discover who owns railway property. From the point of view of social justice the character of the competition invited by this industry brings about an abnormal and unhealthy commercial condition. Rebates, discriminations, secret contracts, and the like, seem to be imposed upon the railway manager by the commercial forces with which the peculiar character of this industry brings him in contact; and the result is that society is deprived of those industrial conditions under which commercial forces for ordinary industries are able to act in a normal manner. Two facts thus become evident: first, that the general property tax cannot secure payment from the proprietors of railway property, and second, that the industry is of such a character as to demand control by the State. If to these facts be added the consideration that railway corporations enjoy a franchise from the State which possesses a peculiar industrial value, it is easy to understand why they have been selected for special taxation. So true is this of the conditions of the United States that when one speaks of a corporation tax the mind turns at once to the question of railway taxes.

Other industries naturally classed with railways for the purpose of taxation are the telegraph and express industries, and, probably, the telephone industry. Indeed, all those industries engaged in transportation possess the same general character. It is true that the great express companies in the United States are organized as joint-stock associations; but the trend of judicial opinion seems to be that for the purpose of taxation they should be considered as incorporated. The telephone industry cannot be so easily disposed of, for it is not yet certain that this industry is subject to the law of increasing returns. Beyond a certain point in density of service it is claimed that operating expenses increase more rapidly than income. If this be true the industry itself sets a limit to its normal size, and separates itself from railways and telegraphs as non-monopolistic in character. Moreover, the telephone industry has in part a local character.

Other industries there are, allied to the great transport industries, that should be made the object of special con-

sideration, as for example bridge companies and companies owning terminals, rolling stock, and the like. The idea is that the transportation industry can be handled the most easily when regarded as a unit, and the peculiar contracts between the various parts of the organized association should not be permitted to secure one form of taxation for one class of property and another form of taxation for another, all of which bears the same social and industrial character.

A second class of industries which possess a character peculiar to themselves, and which on that account call for special treatment on the part of the State, is composed of banks, insurance companies, building and loan associations, and the like. The character of these industries is given them by the fact that they perform in a greater or less degree the duties of trustees. Moreover, competition, while more active and efficient for legitimate control than in the case of railways and express companies, works with them in a peculiar manner. They are subject to the law of increasing rather than of constant or decreasing returns, but the working of this law is so guarded as to free them from the abnormal or excessive competition to which the transportation industry is exposed. The public interest, therefore, does not pertain so much to fair, equitable, and uniform treatment as to the price charged for services rendered and to the security of funds placed at their disposal. From this it follows that the rule of taxation for businesses of this class may with propriety be very different from those rules that are pertinent in the case of transportation industries, but that their character as trustees whose income increases with the volume of their business makes them a fit object of special taxation.

The third class of industries to be considered in the discussion of corporation taxes, although not always organized as corporations, is made up of such enterprises as mining properties, lumber interests, and other natural monopolies. These industries, in so far as they give a differential profit to their proprietors, should be made to share their royalty or rent with the State. The line of reasoning which underlies this conclusion has been already presented in connection with the question of governmental proprietorship of natural monopolies. Some of them, it was there learned, might with propriety be owned by the State, others, on account of technical

difficulties in administration, can with greater advantage be given over to individuals or corporations; but in either case the fund of value stored up by nature in the past may justly be called upon for special contributions for the support of the State.

The fourth class of industries that should receive special treatment at the hands of the revenue system is composed of municipal monopolies, such as street railways, gas companies, lighting companies, and the like. They are mentioned in this connection to complete the series of industries that claim the special consideration of the financier

In closing this brief analysis it may be remarked that what we have here called the question of the corporation tax is in reality a question respecting the proper fiscal treatment of those industries that are superior to the normal control of commercial forces. The corporation tax and the monopoly problem are closely allied, and no satisfactory adjustment of corporate taxation can be expected except it be made under the influence of some general theory respecting the solution of the monopoly problem. The idea which underlies the suggestions of this treatise is that uniform laws of incorporation should be established between the several States, that special rules of incorporation should be drawn for industries that are monopolistic in character, that a prescribed system of bookkeeping and supervision of accounts should be established for all incorporated industries, and that uniformity of legislation should be established between the States for determining the conditions under which corporations may operate. This is admitted to be a comprehensive and an ambitious programme; it is, however, no less comprehensive than the extension of the commercial relations which nineteenth-century corporations have established, and no less ambitious than seems to be the ideal of control which many of these corporations have set before themselves *

* For a very imperfect suggestion of the analysis upon which this program rests, the student is referred to my monograph entitled "Relation of the State to Industrial Action" published by the American Economic Association, Vol. I. While it is admitted that this analysis is crude and incomplete, the general results at which it arrives are believed to be in the main sound. Its chief contention is, and this must be held in mind by the student of finance in studying the corpora-

(2) THE PROPER BASIS OF ASSESSMENT—The industries which demand special treatment by the revenue system having been selected, the second question which presents itself to the financier pertains to the proper basis of assessment. In discussing this question we shall hold in mind primarily the transportation industries, and, of the transportation industries, railway corporations. Not only will this give to our analysis a concrete character, but, with the exceptions to be noted, the general principles arrived at in connection with the taxation of railways are pertinent, in a more or less degree, to the taxation of other industries of this same general class. Corporations may be assessed in either of three ways:

On the basis of their property

On the basis of the volume of business which they transact.

On the basis of their earnings

(a) *Property the Basis of Assessment*—The special treatment of railways for the purpose of taxation which separates itself the least from the principles underlying the general property tax consists in an attempted assessment of property. This assessment may be made in either of three ways. It may be estimated on the basis of the probable cost of the property; it may be arrived at by the capitalization of current earnings at an assumed rate of interest, or the aggregate of bonds and stocks outstanding may be accepted, either at their market or their par value, as representing the value of the property. So far as cost is concerned it requires but slight acquaintance with the history of the railway industry to warrant the assertion that the original cost of railway property is beyond the ability of any man to determine. In the majority of cases the construction accounts of railways either do not exist or they do not exist in the hands of the corporation now owning and controlling the property, and even in those cases where continuity of corporate history permits the original book-cost to be determined it would be useless as indicating ability to bear taxes. Of what significance, for example, is it to know the cost of a road constructed twenty-five years ago when it is remembered that steel rails have

tion tax, that provided the railway problem be solved so as to secure uniform, open and just rates, the tendency toward undue concentration in secondary industries would be, in large measure, if not entirely, arrested.

fallen in price during the intervening time from seventy dollars to twenty dollars per ton, and that locomotives have fallen in price from eighteen thousand dollars to eight thousand dollars? On the other hand there are many items in construction that have risen in value since the original investment. Nor is this difficulty overcome by substituting for original cost the "cost of reproduction," inasmuch as many of the most important constituents of present worth rest upon the fact that the railway exists and cannot be estimated independently of that assumption. Entrance into a populous city, for example, which at the time the railroad was built might have cost but little, would now be the occasion of enormous expenditures, but the value of this right of way was in large measure created by the railway itself, as well as the value of all other abutting property. The truth is the commercial results of a long-established line of communication have become so integral a part of the existing industrial structure that an estimated cost of reproduction would bear no relation to the commercial value of the property.

Generalizing from this analysis and holding in mind all industries that are, from the economist's point of view, monopolistic in character, it may be said that cost is a fact of no significance so far as any of the administrative questions which arise in connection with monopolies are concerned. Cost is of significance only in those industries to which the principle of competition applies, and in which for this reason the cost of reproduction and the capitalized value of earnings tend to coincide. We may, therefore, set aside the idea that cost of property can serve as a basis for the assessment of taxes to corporations.

Neither can the value of corporate property serve as the basis of assessment. The reason for this was in part suggested when it was learned that corporate property possesses a value independent of the earnings or income to which the property gives rise*. The indirect advantages of the control of a large industry are such that men are willing to pay for the property which gives them this control, although they receive no dividends therefrom. Conceding, however, that

* Cf. § 60, (2), (c), (β).

the value of corporate property tends in the long run towards the capitalization of income, it does not follow that it would serve as a satisfactory basis of assessment, for it would not permit the government to adjust its demands to the fluctuating prosperity of the business concerned. The market value of property, in so far as it depends upon earnings rather than upon speculative hopes, must be the capitalization of average earnings extending over a considerable period of time, while the ability to pay taxes of a given year depends upon the earnings of that year. It seems, therefore, proper to conclude that the commercial value of corporate property may be set aside when searching for a proper basis for the levy of taxes. This conclusion will at least be conceded by those who believe that the current expenditure of government ought as a rule to be borne by current production.

Many of the States accept stocks or bonds, or both, either at their par or their market value, as the basis upon which corporate property should be assessed. The theory is that stocks and bonds represent the investment of capital; they are the personal property which in the hands of individuals evades taxation. It seems to satisfy the conditions of the problem that a corporation should pay taxes in proportion to the stocks and bonds it has issued. While many arguments may be urged in favour of this plan, it is not without its limitations. In the first place it must be recognised that the income from bonds is different in character from the income from stocks. The one is interest, the other is dividends. The one is determined by the terms of a contract, the other is contingent upon the earnings of an industry, and it is evident that a tax imposed on a corporation in proportion to its outstanding capital would, in the first instance, tend to depress the value of stocks and to increase the value of bonds. In the long run this difference might adjust itself, but the process would tend to encourage the purchase of corporation bonds and to discourage the purchase of corporation stocks, a result which, from any point of view, must be regarded as undesirable.

Another reason for hesitating to accept outstanding capital as the basis of assessment is that neither the par value nor the market value of stocks and bonds holds any very definite relation to earning capacity. A tax upon the

par value of outstanding railway stocks, for example, must be regarded as unfair when it is remembered that not more than 53 or 54 per cent of such stocks pay dividends. They are, it is true, quoted upon the market because their proprietorship carries with it a definite right of management over great industrial properties. Their possession is a link in control, although, by some reorganization or process of reconstruction, they may have been supplanted by obligations of more recent issue. To make stock a basis of taxation while holding to the idea that payment from property must be in proportion to ability, it would be necessary to separate the active from the suppressed obligations and to assess the former only for purpose of taxation.

It may be urged that the embarrassment here encountered will be overcome by substituting the market value for the par value of the stock. In a measure this is a pertinent suggestion, but it does not harmonize with the principle already accepted that corporations should pay according to their ability. Assessment of stocks and bonds on the basis of market quotations would result in assessment according to the speculative interest which manipulators might have in special stocks. Moreover, the taxation of quoted values (except an average of quotations be taken) would intensify the fluctuation of stocks and bonds, and for this reason is repugnant to a sound view of industrial conditions. The market value of such stocks, however, is little better than their par value, as indicating the ability of the corporations which issue them to bear taxes. In general it may be said that the financial administration of these great properties bears no absolutely fixed relation to their business administration; and on this account neither the amount of stock at any time outstanding, nor the value of that stock upon the market, can be accepted by the State as a measure of their ability to bear taxes. Were there no better basis of assessment, stocks and bonds outstanding might perhaps be accepted, but it must be admitted that the assessment of corporate property on this basis is not satisfactory.

(b) *Volume of Business the Basis of Assessment*—The error of this method of taxation is that volume of business bears no necessarily constant relation to the earnings of corporations, because the earnings depend as much upon the price

charged for services or commodities as upon the amount of business. Some railways, for example, enjoy a passenger traffic of between 500,000 and 600,000 passenger miles per mile of line, while others there are even of first-class roads that must content themselves with a passenger traffic of 20,000 or 30,000 passenger miles per mile of line. In freight traffic there is yet greater discrepancy.* Some roads there are which manage a freight traffic of over 3,000,000 ton miles per mile of line, while others operate successfully a freight traffic of less than 50,000 ton miles per mile of line. It is evident, if charges for service rendered were the same for all companies, and if expenses were in proportion to business done, that the volume of traffic would give a passable measure of the ability of railways to pay taxes. An investigation into the facts, however, shows marked divergence in rates, not only in different parts of the country, but as between railways in the same territory operating under different commercial conditions. Volume of traffic is an uncertain basis of assessment, also, because it is likely to cover a great diversity of commodities and services. What basis of comparison, for example, can be instituted between a road the great bulk of whose traffic is coal, and a road that secures a considerable portion of its earnings from high-class freight? The ton mileage in the former case will be high, while the ton mileage in the latter will be relatively low, but the gross income of the latter may exceed that of the former. Without pressing this analysis further, it may be concluded that the relations which exist between the volume of business in any industry and either the gross or net earnings which result therefrom are so different for different industries, or, indeed, for the same industry at different times, that volume of traffic cannot well serve as the basis of taxation. It is the fiscal result of a business rather than the volume of its transactions which measures the ability to pay taxes.

(c) *Earnings the Basis of Assessment*—It is as true of corporations as of individuals that their ability to pay taxes is measured by their annual income; and, provided adequate means can be devised of disclosing income, little argument

* For table showing density of traffic of all roads in the United States whose gross revenue exceeds \$3,000,000, cf. Eighth Annual Report on Railway Statistics in the United States, pp 112 to 122.

is required to conclude that income in some one of its many phases should be accepted as the basis of the tax levy. But income when applied to corporations is by no means a simple concept. It may mean gross earnings from operations, or gross earnings from operations increased by the receipts that accrue from corporate investments. It may hold in mind a net item, which in its turn is capable of a double interpretation corresponding to the two meanings of gross earnings. That is to say, the expenses that are deducted in order to arrive at a net result may be deducted from either the gross earnings from operation or the gross corporate income. And finally, the expenses to be deducted in order to arrive at the net item may be either operating expenses or operating expenses and fixed charges. There is thus presented a wide range for selection, and it is evident that a law which designs to tax a corporation on its earnings or income must be very explicit in the use of terms. For the purpose of making this matter clear there is here inserted the income account drawn by the Interstate Commerce Commission for the annual report of railways in the United States

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|--|--|
| Gross Earnings from Operation | |
| Less Operating Expenses | |
| INCOME (OR DEFICIT) FROM OPERATION. | |
| Dividends on Stocks Owned | |
| Interest on Bonds Owned | |
| Miscellaneous Income—less Expenses. | |
| INCOME FROM OTHER SOURCES | |
| TOTAL INCOME (OR DEFICIT) | |
| DEDUCTIONS FROM INCOME | |
| Interest on Funded Debt ACCRUED. | |
| Interest on Interest-bearing Current Liabilities ACCRUED, not otherwise provided for | |
| Interest on Real Estate Mortgages. | |
| Rents Paid for Lease of Road | |
| Taxes. | |
| Permanent Improvements | |
| Other Deductions. | |
| TOTAL DEDUCTIONS FROM INCOME | |
| NET INCOME (OR DEFICIT) | |
| Dividends. per cent Common Stock. | |
| Dividends. per cent Preferred Stock | |
| Other Payments from Net Income | |
| TOTAL DIVIDENDS AND OTHER PAYMENTS. | |
| Surplus (or Deficit) from Operations. | |

The first alternative presented to the financier lies between a gross or a net item as the basis of assessment. If, however, one confine his attention to purely economic considerations the decision is not difficult. A tax on the gross earnings of a corporation cannot be satisfactory, because it takes no account of operating expenses incident to the securing of such earnings. In the railway industry, for example, operating expenses average 66 per cent of operating earnings. From this it appears that only 34 per cent of gross earnings from operation are at the disposal of the corporations for the payment of interest on debt, taxes, incidental betterments, and dividends. There are, however, railways in this country whose normal operating expenses are not more than 50 per cent of gross earnings, and others whose operating expenses exceed 75 per cent of gross earnings. It is evident, therefore, that a just assessment as between corporations must take into account expenses as well as earnings.

The second question which presents itself pertains to income from investments as distinct from earnings from operation. Should assessments take any account of such income? The answer to this question depends entirely upon the theory according to which the corporation tax is drawn. If all corporations which maintain a legal existence, whether active or subsidiary, are included in the tax levy, the income arising to a corporation from investments in the securities of other corporations should be free from taxation, because the business which gives value to its investment is itself taxed. If, on the other hand, the tax law addresses itself exclusively to operating corporations, their income from investments should be added to their earnings from operations to secure a just basis of taxation. The controlling consideration in this matter is found in the fact that a portion only of the securities of inactive or leased corporations is held as an investment by operating companies, and, this being the case, should the operating company be taxed upon its entire corporate income, while subsidiary companies are released from the duty of payment, the result would be that corporate investments in corporate securities would be taxed, while private investments in the same class of securities would be free. There seems, then, ample reason for concluding that the tax law should address itself to all corporations, whether active

or not, which is equivalent to saying that the earnings from operation, rather than the earnings from operation plus the income from investments, should be accepted as the starting-point in tracing the ability of operating corporations to pay taxes. In the case of leased companies the rental, or income from the lease, should be the basis of the tax.

Corporate earnings rather than corporate income being accepted as the object of assessment for operating companies (inactive corporations may now be dropped from view), and a net rather than the gross item having been preferred, the question then presents itself whether the "income from operation" or the "net income" should be selected as a measure of payment. These phrases are technical in character. A corporate earning is converted into an income by deducting from it the expense of operation. If operating expenses alone are deducted the remainder is called the "income from operation", but if capital expenses are also deducted, such as interest, rents, taxes, improvements charged to income account, and the like, the remainder is called the "net income". The difference between these funds may be suggested when it is recognised that the former is a net item to the corporation considered as an industrial association, and is charged with all liabilities that accrue under contracts, or arise from the policy of the administration, or are imposed by the authority of the State or the terms of the charter, the latter is a net item to the directors of the corporation considered as trustees, and as charged with the duty of declaring to shareholders the amount of their profits.

As between these two funds it is the former rather than the latter which should be selected as the basis of the tax levy, a conclusion for which several reasons may be presented. First, this places the government on the same footing as the investor in bonds and in stocks, and is in harmony with the idea that the State should appeal to revenue at its source. Of more importance is the consideration that operating earnings and operating expenses are about the only terms in corporation bookkeeping which may be interpreted strictly and in a fairly uniform manner. They pertain to the administration of officials rather than to the policies of directors. One difficulty which attends

the administration of corporation taxes is found in the fact that corporations are tempted to manipulate their accounts, but such manipulation would be exceedingly difficult so far as the two classes of items referred to are concerned. It is of great importance that the government should select as a basis of taxation a fund that can be determined by the regular application of accepted rules of accounting. This is true of net earnings from operation. It would be a flagrant abuse of authority, and one easily discovered, should the management of a corporation increase or decrease, in an arbitrary manner, either earnings from operation or operating expenses. The only legitimate consideration against this conclusion is that operating expenses may be unduly increased by the voting of large salaries. To this we reply that, inasmuch as the State has the right to compel the itemization of expenses, the tax may be increased to the corporation that pays too high salaries, leaving it to the stockholders to elect a board of directors that shall reduce the salaries rather than the dividends. The claim that betterments and taxes will be included in operating expenses does not hold, for the argument proceeds on the assumption that the State will prescribe accounts.

The chief reason, however, why income from operation should be accepted as the basis of taxation is that it is the surest indication of the earning capacity of a business. It is a much better index of what a corporation can pay than final net income, inasmuch as this latter fund is so largely dependent upon the general policy of the company. Income from operation is the fund which, other things being equal, fluctuates with the general prosperity of the nation. Its increase or decrease from year to year indicates ability to pay taxes at the time of payment. The net income, on the other hand, may be relatively small when earnings are large or large when earnings are small, on account of the fact that in prosperous years corporations are tempted to incur a very considerable number of expenditures which in less prosperous years would not be incurred or would be provided for through the construction accounts. We may, then, conclude this analysis, which has suggested at least the lines along which the selection of a basis for the corporation tax should proceed, by affirming that earnings rather than pro-

perty should be accepted as a basis of the corporation tax, and that gross earnings less operating expenses, that is to say, "income from operation," measure most perfectly the relative duty of corporations to pay for the support of the State.

(d) *Special Cases of Corporation Assessment*—The above analysis pertains primarily to railway corporations. Do the conclusions to which it leads require any modification when applied to the other classes of corporate or monopolistic industries? These industries are, it will be remembered, banks, general trust associations, natural monopolies, and municipal monopolies.

So far as banks and allied businesses are concerned, it is believed that volume of business may be safely selected as the basis of special taxation, for this, rather than any other factor, indicates the ability of the business to pay. The business has no cost that can be estimated. It has no value apart from the continuity of its business. To assess on the basis of capital stock would be without reason, inasmuch as trust companies do not limit their business to the proceeds of their stock, but make the larger portion of their profit out of the use of money furnished them by their customers. To tax on the basis of net earnings, which calls for the segregation of current expenses, would require administrative machinery that would serve no good purpose to any other department of the government than the financial department. Moreover, the operating expenses of a bank when compared with its income are of relatively small importance. Nor is there any reason why gross earnings should be selected as the basis of assessment in preference to the volume of business, inasmuch as these earnings accrue upon the business at a fairly uniform rate of profit. If, then, gross earnings and volume of traffic amount to practically the same thing (an assumption found to be incorrect when applied to the railway business) the financier is at liberty to select as the basis of assessment the item that may be the most easily discovered from the books of the business in question. This item is volume of business. The books of banks and trust companies recognise neither gross nor net earnings in the technical sense of those terms.

In applying this rule of assessment care must be taken not to duplicate the tax. If loans and discounts of a bank

are taxed its capital stock should be freed from taxation; if the premiums of an insurance company are taxed the investments which guarantee them an income with which to pay unusual losses, or which secure to them accruing assets with which to balance the accruing liabilities, should be free. The only exception to this rule is that under some conditions it may be wise to include the real estate of corporations of this class in the general property tax of a county or the rental tax of a municipality.

The special taxation of natural monopolies presents a slightly different problem. Under natural monopolies, it will be remembered, are included mines, forests, and in general all property of unusual value on account of the fact that nature has localized commercial products. This gives rise to a royalty that competition cannot touch, and it may be accepted as an established principle by all schools of economists that a royalty which particularizes itself is properly made the occasion of special assessments. The basis of taxation in these cases should be the royalty accruing from the property, and the rate at which this royalty is taxed should vary with the peculiar conditions of each case.

Municipal monopolies, this being the fourth class of industries selected for special taxation, should be treated in the same manner as railway corporations, except that in the case of street railways, lighting companies, water companies, and the like, the municipality is justified in placing greater emphasis upon the fiscal interests of the municipality itself. In a properly adjusted system of railway rates the charges will be such as to minister in the highest possible degree to the social utilities and the industrial development of the State, and the question of taxation must in a degree be subordinated to these considerations; in the case of municipal monopolies, on the other hand, there does not seem to be so clearly marked an antagonism between the fiscal and the social interests. The same line of reasoning, however, may be relied upon in the selection of the proper basis of assessment in the one case as in the other, and the conclusion of that reasoning would be that so long as municipal monopolies are intrusted to the management of private agencies the net income from operation should be accepted as the basis of taxation.

(3) *THE RATE OF CORPORATE TAXATION.* — The third

question that arises in connection with corporation taxes pertains to the rules by which rates may be determined. That which gives character to the corporation tax, as the phrase is here used, is that the industries which it includes are, for one reason or another, industrial monopolies. This being the case, it is not possible to rely upon commercial forces to equalize the commercial burdens of the tax, and on this account the financier undertakes to accomplish this equalization by artificial means. It is at this point that excise duties separate themselves from corporation taxes.

Lest our reasoning be convicted of inconsistency at the outset, it may be well to explain the difference between a money lender whose mortgages are to be exempt from taxation, according to the conclusions at which we have arrived in discussing property taxes, and the banker whose business is to be taxed. "The distinctive function of the banker, says Ricardo, 'begins as soon as he uses the money of others'; as long as he uses his own money he is only a capitalist"*. Now a tax upon the discounts of a bank are not a tax on the loaning of money, but upon the industry of collecting money for loan; a tax upon the premiums of insurance companies is not levied on investments, but upon the business of selling risks. A corresponding statement might be made for any of the cooperative trust or investment companies. In so far as the interest derived from loanable capital affects the earnings of this class of corporations the remission of taxes on mortgages and loans will work to the reduction of those earnings; and there is no inconsistency, therefore, in imposing a special tax upon banks, the agencies of loans, and of remitting loans themselves from taxation. Loans and discounts are accepted as the basis of taxation of banks because they measure fairly well the earnings of these corporations, and in determining the rate of taxation care must be taken lest this tax be raised to such a point that it is converted into a tax on loanable capital. With this explanation we may proceed in our discussion of the rate of corporation taxes without fear of misunderstanding on account of the peculiarity of the business of banks and trust companies.

Returning now to the assertion that a corporation tax is

* Bagehot, *Lombard Street*, p. 21.

a tax on monopolistic earnings or on differential profits, and for this reason is unaffected by the equalizing tendencies of commercial forces, it seems natural to conclude that the rate of taxation as between corporations ought to be adjusted in harmony with their differential profits; which means that the theory of progressive taxation should control the adjustment of rates when applied to corporations. Many States attempt to realize this in their taxation of railways. In Michigan, for example, railways are divided into three classes according to their net earnings per mile of line, and a different rate is imposed upon each class. This is an application of the progressive system of taxation, and is supported by all the considerations urged in favour of that principle. There are, moreover, special reasons why many corporations should be taxed progressively. In case of *quasi*-public industries the State should share with the companies in the constantly increasing value of the franchise which it grants. In many corporations, also, the increment of traffic accrues as the result of social growth, and cannot be taken away by the competition of new industries, while the rate of profit on this increased traffic tends to increase because operating expenses do not expand in like proportion. It thus appears that in the case of a purely industrial monopoly there does accrue an "unearned increment" which varies in amount as between corporations with their age, their location, and their past fiscal history; and it is certainly just that the rate of taxation should vary with the more or less advantageous situation of the corporations in question. So far as the basal rate is concerned, as well as the rapidity with which the rate shall increase with increased earnings, no rule can be laid down except in the presence of known fiscal and industrial conditions. The schedule of rates should not be so high as to secure from corporations more than the government needs for just expenditure, nor should the progression of the rate proceed so rapidly as to discourage industrial betterments. These, however, are considerations which find their true measure in a policy of public expenditures on the one hand and in the policy of industrial organization on the other. Our conclusion is that special taxes of all sorts, whether they apply to differential profits, royalties, or loans, are legitimately subjected to the principle of progressive taxation.

71 Administrative Questions Respecting Customs and Excise Duties — Customs and excise duties pertain to industries that are open to competitive regulation, and all rules of administration that apply to them should be framed in full recognition of the commercial laws by which these industries are controlled. In considering these taxes it is necessary to hold fast to the assumption relied upon for exempting mortgages and credits from taxation, namely, that commercial laws do work. All industries properly charged with customs or excise duties are such as carry the payment of the tax to the consumer, and which permit such a shifting of commercial conditions that the "burden" of the tax tends to equalize itself. This equalization will show itself easily as between competing industries. But, granting sufficient time, the same commercial forces will produce similar results between non-competing industries. This means that the amount of capital, the rate of profit, the rate of wages, indeed all the elements of production and all the conditions of consumption, do tend to proportionalize themselves in the same ratio as would be the case were there no tax.

(a) *Choice of Articles for Import Duties* — The liberty which confidence in commercial forces grants the financier is nowhere more welcome than in connection with excise and customs duties, for it enables him to substitute a simple for a complex revenue system. This he may do by a judicious selection of industries to be taxed, and by placing the products of all other industries on the list of free commodities.

Without bringing the question of free trade or protection into the controversy, the revenue reform of England, which took place between 1842 and 1862, is believed to indicate the true principle which should control the administration of customs duties. The number of articles charged with duty at various periods in the interval is truly instructive.

| | | | | | | | |
|---------|-------|------|---------|------|------|------|-----------|
| In 1841 | there | were | charged | with | duty | 1163 | articles. |
| " 1845 | " | " | " | " | " | 1052 | " |
| " 1853 | " | " | " | " | " | 466 | " |
| " 1859 | " | " | " | " | " | 419 | " |
| " 1862 | " | " | " | " | " | 44 | " |

The gross produce of the customs' duty was:

| | |
|--------------|----------------|
| In 1841..... | ..\$21,898,845 |
| " 1851..... | ..22,373,662 |
| " 1861..... | ..23,516,821 |
| " 1862..... | ..24,036,000 |

So far as England is concerned it cannot be doubted that the marvellous expansion of foreign trade which marks the last half century was rendered possible by the simplification of her customs laws. It is also apparent that revenue did not fall with the reduction in the number of articles taxed, for the stimulus given to commerce, coupled with a judicious selection of the commodities upon which the duties were imposed, enabled the government to obtain a larger quantity of revenue at less cost from 44 articles in 1862 than from 1163 articles in 1841. There seems to be a popular impression that the revenue reform accomplished by England is in some way bound up with the theory of free trade. It is true historically that the reform was brought about as the result of an agitation in favour of an untrammelled commerce, but the reform itself rests upon the principle of simplicity in revenue laws and was carried out by the judicious selection of the objects to be taxed. One cannot say, in the absence of experiment, that a protective system of customs duties could rival in simplicity the English system of free-trade duties, but it is evident, were the problem approached in the proper spirit, that the number of articles taxed could be materially reduced, notwithstanding the fact that revenue laws were expected to foster the development of domestic industry as well as secure a revenue to the State. The lesson to be learned from the experience of England is that, from the fiscal point of view, a simple system based upon a few judiciously chosen commodities will give better results than a system which presents the appearance of being comprehensive because it embraces nearly every commodity known to manufacture or trade.

An appreciation of simplicity in revenue laws naturally suggests the query, What commodities should be selected for a system of customs or of excise duties? The principles for making such a selection are well established. So far as cus-

toms duties are concerned it is first necessary to ascertain what effect upon domestic industry it is desired the revenue system should exert. It cannot be neutral, for it constitutes one of the established conditions of manufacture and trade. Is it desired that the theory of "protection" or the theory of "free trade" (these phrases are used to suggest a class of ideas) shall give character to customs laws? If the former, the commodities taxed on importation must be such as the importing country can itself produce, but which under an unrestricted commerce it would not produce, or would not produce in adequate amount to meet the established demand. For example, applying this generalization to the United States, tin, woollens, sugar, pottery, and silks are such commodities. If that set of ideas carried by the phrase "free trade" controls the purpose of the legislature, commodities selected for import duties must be such as cannot be produced, at least with any reasonable certainty, within the importing country; such, for example, as coffees, teas, spices, certain kinds of woods, wools * (if one have regard to the great variety needed for a highly diversified industry), and others of like nature. Upon this point there is no question.

All publicists would agree to this statement of the question. The more difficult part of the problem arises when it becomes necessary to make selection within the groups placed at the disposal of the financier by the industrial policy which controls political sentiment. Although a difficult problem the principles that underlie it have been pretty well established by the practice of nations. It makes no difference what system of excise or of customs duties one studies, or in what period of history the study is undertaken, the controlling consideration has always been the necessity of obtaining funds. It is imperative, therefore, that those commodities be selected which will bear the tax imposed, and which, notwithstanding the increased price, will continue to be consumed in sufficient quantities to produce the needed revenue. This being the case, it is clear that those commodities which

* This is contrary to the current tariff-reform programme in the United States, but in this particular the current tariff-reform is illogical. Wools not grown in this country should be taxed provided the government needs the revenue, and the manufacture given a compensatory though not a protective duty on imported woollens.

satisfy the ordinary and personal demands of life for the great mass of people must be selected for taxation, for these are the only ones that can be productive of sufficient revenue, and, should the financier desire to establish a permanent system of import duties he must select those commodities of ordinary consumption that come from countries industrially dissimilar to his own. Peoples living in temperate climates, for example, must secure their revenue from duties imposed on goods purchased in southern climates, for it is evident that a tax on the goods of peoples of similar industrial conditions will sooner or later lead to the production of such goods at home. This would destroy trade and consequently defeat revenue. A similar remark may be made respecting trade between Oriental and Western civilization. Each people, as the result of centuries of industrial life peculiar to its own tastes and habits of consumption, has developed facilities, skill, and aptitude peculiarly its own, and a trade more or less permanent will spring up naturally between them. Each nation, therefore, can select for taxation those commodities which must be obtained from the other nation. Such commodities may be made the basis of a permanent system of import duties.

Most revenue systems that make use of import duties do not, however, lay very great stress on permanency of legislation. In this they are at fault, but such unfortunately is the case; and perhaps the most serious problem which the financier encounters pertains to the selection of goods for bearing import duties, in the case of international trade between peoples whose industrial conditions are more or less similar, so far as the gifts of nature, the character of demand, and the development of industrial skill are concerned; and nothing but a scientific analysis of the relative industrial conditions of nations, and a strict application of the economic doctrine of "comparative cost,"* can save a system of import duties from confusion and constant readjustment which has the temerity to repose itself upon competitive international trade.

Without undertaking an explanation of this doctrine, a word may be said to suggest its bearing upon the selection

* For discussion of this doctrine, see J. E. Cairn's *Some Leading Principles of Political Economy*, Part III, Chapter I.

of commodities for import duties. Stripped of technicalities, it means that each nation has facilities for producing certain commodities that are superior to its facilities for producing other commodities, and that, so far as any particular nation is concerned, the normal expansion of international trade must result in the exportation of those things for the production of which relatively greater facilities are enjoyed, and the importation of those things which can only be produced at the expenditure of relatively greater cost. The commercial comparison which determines what goods shall be exported and what goods imported is a comparison between two ways of expending a given amount of capital and labour. It has nothing to do with the relative cost of production in the home and the foreign country, but with the comparative cost of producing different goods in the home country. The home country may be superior to a foreign country in the production of every conceivable commodity, and still it may be advantageous to trade with the foreign country. This is true because the people in question have not developed equal skill in the production of all things, and, so far as they are concerned, can reap an advantage in exporting the surplus of those things which they produce with the greatest facility, receiving in return those things which by comparison they can only produce at a greater comparative cost.

In case a nation has adopted the theory of protection, while at the same time admitting the desirability of an extended international trade, this doctrine of comparative cost may be relied upon to indicate the industries that should be selected for bearing protective duties. It is evident that no amount of protection can within a reasonable time bring an industry which stands high on the scale of comparative cost to the condition of an independent and self-supporting industry. The true policy, therefore, is to permit the products of such industries to be imported with little or no duty, and to employ these imports as an encouragement for the exportation of those goods that stand low in the scale of comparative cost. Commodities to which the principle of protection may be rationally applied are those which in the matter of cost stand just below the self-sustaining industries. It thus becomes evident that the doctrine of comparative cost does

not, as many seem to assume, hold peculiar relations to the theory of free trade; the truth is that nothing but its strict application can rescue a system of protective duties from becoming an unintelligible mass of unrelated rates. Our conclusion, therefore, is that the selection of commodities for taxation must be made in harmony with the commercial principles that underlie international trade, and that these principles are very much the same, though they may lead in their application to divergent results, whether a people has adopted the policy of free trade or of protection.

One further thought suggests itself in connection with the selection of commodities for the purpose of customs and excise duties. No tax, however levied, is free from industrial results, and should the financier desire to confine these results within the narrowest possible sphere, he must frequently avail himself of compensatory duties, that is to say, of duties imposed upon certain commodities because of a tax levied upon other commodities. Compensatory duties come to be of extreme importance when a government includes within the same revenue system a tax on goods imported from without a country and a tax on goods manufactured within a country. For example, the internal revenue system of the United States secures large payments from an excise imposed upon the manufacture of tobacco and the distillation of spirits. A corresponding duty must of course be imposed upon the importation of tobaccos and spirits, since otherwise the effect of the excise duty would be to compel consumers to purchase the imported articles. The principle of compensatory duties shows itself, also, when a protective policy designs the encouragement of an industry at various stages in the process of production. In this country, for example, it is the purpose of the government to encourage the growth of wool and the manufacture of woollens at the same time. Now it is evident that a duty imposed upon the importation of wools will, in so far as it tends to raise their price, act as a discouragement to the development of woollens; it is necessary, therefore, to add to the duty upon woollen goods a rate which shall compensate for the rate already imposed upon the raw material. In the American system of customs duties this principle is fully recognised. In the case of woollens, just cited, the duty imposed upon the value of the goods is as-

sumed to be protective to the manufacturer; while the duty of so much per yard is recognised as compensatory for the duty imposed upon wool, and is adjusted so as to cover the rate paid by an amount of wool necessary for the production of a given amount of cloth. Whether, therefore, one considers the equalization of industrial conditions as between the producers of the same commodities under different conditions, or the restoration to an industry of a protection granted to it, but which is rendered ineffective by a tax upon one of its constituents of cost, the principle of compensation must be brought into play. It is, indeed, a principle to which any system of internal taxation must make frequent appeal.

(b) *Choice of Articles for Excise Duties*—Our discussion has thus far held in mind primarily import duties; what, it may be asked, determines the choice of industries to be taxed in a system of excise duties? This subject has never been the occasion of much practical difficulty in the United States because it has been regarded primarily, if not exclusively, as a question of revenue. An excise duty cannot be a protective duty, and while sentiment respecting certain commodities conceived to be prejudicial to public morals may perhaps have influenced legislators in framing an excise system, it has never, like the highly individualized sentiment of protection, been strong enough to subordinate to itself fiscal considerations. Revenue being the object of internal duties, and the taxes themselves being paid by the consumer, the rules which guide the financier in the choice of objects to be taxed are simple and clear. He must select those goods that are of general or universal consumption, and inasmuch as these taxes are indirect, and therefore tend to the equalization of commercial conditions, *provided* the legislature is willing to leave them alone long enough to work their normal results, the choice of objects comes to be very largely a matter of administration.

While this statement may be accepted as a general truth, it must in practice be modified by three considerations which present themselves in the nature of exceptions to the general rule of scientific indifference respecting the choice of commodities selected for taxation.

In the first place, a system of internal duties may include instruments of commerce as well as products of industry;

and the industrial results of taxing instruments of exchanges, or papers incident to business organization, are not quite the same as those which follow the taxation of industries on the basis of their output. The stamp duty on bank checks, for example, will tend to decrease the use of checks in small payments and to increase in a corresponding degree the use of cash payments. This may or may not be advantageous according to the industrial conditions in which a country finds itself; but, speaking generally, it would seem to be unfortunate that a people accustomed to payment by bank checks should be discouraged to continue this most economical of all methods of effecting exchanges. A tax on bank checks might go so far as to become a serious element in a money stringency. Stamp duties imposed on deeds or upon stocks and bonds would not be open to such serious objection, but these also violate the principle that any impediment to the development of industrial association or to the exchange of property will tend to render readjustment in the industrial organization unnecessarily sluggish. Our conclusion, therefore, is that, in the selection of objects to be taxed in a system of internal duties, it is better to choose the industrial product than the instrument of exchange or of industrial association.

A second modification of the above generalization arises from the fact that goods vary in the intensity with which they are regarded by consumers, and that, for this reason, the tendency toward commercial readjustment varies according to the goods upon which the tax is levied. To be explicit, the shifting of commercial conditions due to a tax on goods that can be spared without much inconvenience meets with less obstruction than the shifting due to a tax imposed upon the necessities of life; the reason being that the former takes place through a readjustment of the relative consumption of different classes of goods, while the latter must work its way out through a readjustment in the scale of wages. Now the former is a much more easy process than the latter; and inasmuch as it is the desire of the financier to facilitate those readjustments incident to the levy of any tax, it follows that he will, other things being equal, select those commodities for taxation which lie above the necessities of the labourer's life in the scale of current living.

The third modifying consideration has nothing to do with industrial analysis. Inasmuch as the science of finance expresses indifference respecting the choice of goods to be taxed in an excise system, opportunity is given for minor interests to exercise a controlling influence. This is undoubtedly the reason why in reducing internal taxes from the enormous figure which they reached in the United States in 1865 the taxes on practically all articles except tobacco, spirits, and malt liquors have been repealed. Some revenue from this source being needed, the moral sentiment of the community against the goods in question, or at least the common opinion that they are not necessary for rational living, caused their taxation to be maintained, while taxes on other goods were remitted.

There is one question respecting both customs and excise duties that cannot longer be set one side: Are these duties just? Can they be levied with equity? Is it possible to arrange them so as to call for payment from citizens in proportion to their respective abilities? It is common to answer these questions in the negative, and to rely for the defence of these duties upon the imperative fiscal needs of the State.

Before venturing an opinion upon this point it may be well to explain what is meant by the "injustice of indirect taxation." Assuming payment in proportion to ability to be the just basis of assessment, and assuming income to be the true measure of ability (whether the rate for payment be progressive or proportional is not important to this discussion), it is certainly true that any scheme of internal duties yet devised calls for a larger proportional payment from a man of small or average income than from a man of large income. The reason for this is that a system of indirect taxes cannot be productive except it adapt itself to goods of general consumption, and of this class of goods the wealthy man will not consume very much more than the man of ordinary income. Should the financier endeavour to correct this inequality by imposing a relatively higher rate on luxuries, so as to secure a larger payment from the wealthy than from the well-to-do, he will find that any rate adequate to set aside the criticism will tend to check revenue from this source. The explanation of this has already been given in the foregoing discussion upon rates.

While the above statements are true, we are not sure that they rest upon a complete analysis of the situation. The student must again remind himself that commercial laws do work in the case of industries to which indirect taxation pertains, and this means that, in the long run, when measured by their respective standards of living, the same relative position of classes would exist with the taxes as without them. If this be true one cannot rightly say, because a man of five hundred dollars income pays a higher per cent of that income in indirect taxes than the man of ten thousand dollars income, that he on that account is unjustly treated, for the tax on the goods which he consumes is one of the conditions under which wages and profits are determined. The inequality of which complaint is justly made, when one considers the relative condition of industrial classes, does not lie in the taxing system, but in the industrial order to which that system is applied. To present this thought in another way, the tax paid on consumable goods is, to employ a mathematical phrase, a constant, and the struggle between employer and employé for the division of their joint product can go on just as well, and attain the same relative results, with the tax as without it. The lessons which the financier should learn from the criticism that indirect taxes do not adjust themselves to the ability of citizens to pay are: first, that it is his duty to set his face against capricious and frequent changes in the law of indirect taxation; and second, that his scheme should develop along the line of least resistance, judged by the shifting of commercial conditions. The controlling consideration, so far as both customs and excise duties are concerned, is found in those industrial laws according to which commercial conditions adjust themselves to an established taxing system. There is no reason, so far as justice is concerned, for abandoning indirect taxes.

72 Administrative Questions respecting the Income Tax.—"It is only within the last century," says a recent writer, "that a general income tax, imposed alike on profits derived from property, from trade and commerce, and from personal exertions, has become a normal method of levying taxation."* One of the marked tendencies of tax reforms—

* *Palgrave's Dictionary of Economics*, Article *Income Tax*.

such is the conclusion of another writer after passing in review the fiscal legislation of the last quarter of a century—is the ever greater reliance placed by statesmen upon the taxation of incomes.* According to the analysis submitted by this treatise, however, a general income tax can never be a just tax, while retaining the simplicity of an income tax, because the object upon which it is based does not possess industrial homogeneity, and the conclusion at which the analysis arrived was that, with the exception of professional incomes, salaries, and undertakers' profits not covered by the corporation tax, other forms of taxation should be substituted for the income tax. Shall we follow the observed "trend" in tax reforms, or shall we hold to our analysis? The discussion of this question has been reserved for the present chapter, which deals with the administrative features of taxation, because its answer depends very largely upon administrative considerations.

The oldest of modern income taxes, and perhaps on the whole the most successful, is the income tax of the United Kingdom. It is the purpose of this tax to charge a duty upon all incomes subject to the jurisdiction of the government, irrespective of the residence of those to whom they accrue or of the source from which they accrue. The rate is general upon all incomes and, with one exception, uniform. The duties imposed by the English income tax are ranged under five schedules, as follows: "Schedule A imposes a duty on the owners of lands and houses in the United Kingdom; Schedule B on the occupiers of lands in the United Kingdom; Schedule C on annuities, dividends, and interest payable in the United Kingdom on government securities, British, colonial, or foreign; Schedule D on annual profits arising to persons residing in the United Kingdom from any kind of property wheresoever situate, or from any profession, trade, employment, or vocation wheresoever carried on; on annual profits arising to persons not resident in the United Kingdom from property wheresoever situate, or from any profession, trade, employment, or vocation exercised in the United Kingdom; and on interest of money, annuities, and other annual

* Seligman, *Essays in Taxation*, Chapter on *Recent Reforms in Taxation*.

profits and gains Schedule E on income derived from public offices or employments of profit, and on annuities, pensions, or stipends payable by Her Majesty or out of the public revenue of the United Kingdom" *

The object of this classification of incomes is purely administrative, its purpose being to enable the government to arrive at some easy means of assessment. The practical difficulty inherent in an income tax is that the government cannot get at the income, and to overcome this difficulty the English income tax makes use of two administrative principles. In the first place, it seeks out those incomes which rest upon contract or permanent industrial relations and accepts the contractual income as the basis of assessment; in the second place, it seeks out the source of income whenever that is possible, and assesses the tax to the industry, the corporation, or the agency from which the income springs or through whom it is paid. Two or three specifications will make this clear.

Under Schedule A, which is designed to assess the income of the landlord, the basis of the assessment is the rack-rental of the property. This in the long-run under a system of free tenure will be what the tenant pays for the occupancy of the land. It is an assessment upon a contractual relation that may be easily discovered. Such an assessment works fairly well for the same reason that a tax assessed to the value of landed property works well. Both landed property and the income that accrues from ownership of landed property are simple economic quantities and both are easily determined. There is practically no difference between a tax on the landlord's rent and a tax on the value of land. In the case of occupiers, also, the rental value of land is made the basis, if not the measure, of assessment. For these two classes of incomes, therefore, the question of assessment is settled, and the declarations of taxpayers are confined to the presentation of reasons why any particular assessment may be too high. It must be admitted that in so far as incomes are represented in contracts an income tax works very differently from the manner in which it works when the assessor must rely at the outset upon the declarations of taxpayers.

* Quoted from article in *Palgrave's Dictionary of Political Economy*.

cism that the Income Tax Acts of Great Britain do not separate incomes that may be taxed at their source from incomes to which the principle of self-assessment in one form or another must pertain. That portion of the problem which remains unsolved would at least in this manner have been rendered somewhat clearer.

Can personal incomes be assessed, or must the student accept the degrees of success attained in England as all that can be hoped for, and content himself with a system of taxation that secures payments from landlords' rents and from incomes that may be "tapped" at their source? This is a pertinent question quite independently of its bearing upon what is technically called income taxation. As a matter of fact the English income tax has not advanced the administrative theory of taxation in so marked a degree as many seem to think. The general property tax so far as it pertains to real estate is the same thing under another form as Schedule A of the English income tax. The principle of tapping revenue at its source is the principle upon which the corporation tax rests for its administrative defence. A country, therefore, that retains the general property tax so far as land values are concerned, and substitutes the corporation tax for the taxation of personal property, attains the same general results as are attained by applying these two administrative principles of assessment under a system of taxation that is called an income tax. Neither the one system nor the other obviates the criticism that personal incomes escape taxation. It is at this point that advance in the science of taxation must be made.

How may personal incomes be assessed? Holding in mind the application of the principle of taxing incomes at their source made by the corporation tax, rather than the English income tax, it is evident that its success is due to the fact of industrial organization. It is because the corporation exists as an industrial personality that the government can appeal to it for a share of its earnings instead of to the stockholder for a share of his income. Were industries not organized in such a manner as to necessitate a tangible record neither the corporation tax nor the corresponding duties of English income tax could hope for success. This lesson is the same as that already learned in connection with the taxa-

tion of personal property in mediæval towns. That property was organized for industrial use in such a manner that the agent of the government could get at it through the organization, and the claim which we now submit is that the same administrative principle may be employed in the case of personal incomes. The rule of self-assessment which relies on the individual to declare his income is no assessment—at least no just assessment—and the only hope of arriving at personal incomes is to so organize those who receive them that they will present themselves for taxation as a class and not as individuals.

We are not dependent upon theory alone for the presentation of this idea. In the Prussian business tax the student may see the principle of self-assessment through organizations of taxpayers applied in such a manner as to be fairly successful. The characteristic feature of that portion of the Prussian system of taxation to which reference is made consists in a double classification of industries: first, according to the nature of the industry, and second, according to the probable income of groups within the industry. Keepers of hotels, for example, are constituted a class by themselves, and thus separated for purpose of taxation from druggists or hardware merchants. The justification of this separation is that hotel-keepers are in receipt of an income that possesses an industrial peculiarity of its own. It is the resultant of capital, work, and sagacity that does not pertain in like proportions to any other business. But the respective incomes of hotel-keepers differ greatly one from another, and in order to assign to each the duty to pay taxes in proportion to his ability a further rough classification is made on the basis of probable estimated income. Thus the rental value of the premises occupied, the size of the town to which the classification applies, or any other significant criterion may be made the basis of this classification.¹ Or, what would probably be better, this classification might be made under the guidance of statistical investigation into the character, nature, and situation of industries. Assuming the classification to have been made, the final step in working out

* For a study of the application of this principle of classification to the problem of taxation, the student is referred to the "*patent*" tax in France. Cf. Say, *Dictionnaire des Finances*, article, *Patentes*.

the principle of self-assessment is for the government to say how much it requires from each class, and to authorize the appointment of a board of assessors by each class from among its own members, whose duty it shall be to apportion the amount required to individuals. The rule adopted in Prussia for making this assignment is that the law should determine an average payment, which, multiplied by the number of individuals in a class, determines the aggregate of the class tax. In the case of hotel-keepers, for example, the law might say that an average payment of twenty-five dollars would be expected from all the hotel-keepers in a given city; assuming one hundred hotel-keepers, this would result in a tax upon this business of twenty-five hundred dollars. So far as the apportionment of the tax is concerned the law does not undertake to limit the maximum payment that may be imposed by the assessors on an individual; it does, however, prescribe a minimum below which the assessment cannot fall, and this tends to obviate disproportionately high assessments.*

Two reasons may be urged for the confidence that the principle of self-assessment administered through the organized agency of the interests concerned will work to the advantage of the taxing system:

First The task imposed upon public officials under this method of procedure is one that any fairly decent government can perform with ease and satisfaction. The classification of industries and professions has been considered by every statistician who deals with industrial relations. To be explicit, legislators might accept the classifications of the Tenth Census of the United States without incurring the risk of serious mistakes. Moreover, it must be remembered that this form of self-assessment is to be confined to such incomes as are not touched by the general land or real-estate tax or by the corporation tax, a fact that narrows very materially the scope of the problem in hand. The determination of the average payment presents no insuperable difficulties. As a scientific problem this is one that could easily be solved by the application of statistical methods. All that is needed for the assignment of the average rate to the

* For a careful presentation of the Prussian business tax, the student is referred to an article by Dr. Joseph A. Hill, *Quarterly Journal of Economics*, Vol. VIII.

several classes is to know the relative average income that accrues to the several professions or industries. It is the function of statistics, which takes men in mass, to portray the average man, and it is the idea of this form of self-assessment that the public official should proceed no farther than to assess the class on the basis of an average income.

Second. The task of assigning to individuals the amount which each must pay—a task in which government officials always have failed and always will fail—is given over by the plan under consideration to the persons to be assessed. Not only is the assessment placed in the hands of those who are the best acquainted with the intricacies of the business or profession under consideration, but the assessors themselves are chosen from the members of the class to be assessed. Under such conditions the authoritative assignment would undoubtedly be intrusted to the best men in the class, and by this means the higher rather than the lower moral sense of the taxpayer would be brought to the service of the taxing system. The immoralities of the immoral would be held in check by the self-interest of the shrewd.

This argument may be expressed in a sentence. False returns of individuals respecting their personal incomes, assuming it to be the choice of government to arrive at the average payments by the statistical method, will not vitiate the result, because in the mass of returns this source of error may be assumed to exist in like proportion for all the classes; in the assessment of the real tax to individuals within each class, on the other hand, there is no likelihood that false statements will be accepted, inasmuch as the evasion by one member of a class of his just payment imposes an unjustly high payment on the other members of the same class.

With regard to the administrative principles of assessment upon which a comprehensive income tax must rely, our conclusion is that there are three such principles. First, in the case of contractual incomes the contract may be accepted as the basis of assessment; second, in the case of incomes existing in a fund before distributed to individuals the government may address itself to the fund; third, in the case of personal incomes the taxing system must rely on the principle of self-assessment by organizations of taxpayers.

The foregoing analysis has made it evident that the Eng-

lish income tax is not a simple tax, but that, as Mr Gladstone once remarked, "it is rather a system of taxation." This being the case, it may fairly be brought in comparison with the system approved by this treatise, which makes use of the land tax, the corporation tax, and the taxation of personal incomes. It is to this comparison that we now turn our attention. The choice of a revenue system must be finally controlled by its adaptation to the legal structure and industrial organization of the people who are to pay taxes under it, but in emphasizing administrative considerations one should not lose sight of those fundamental principles of equity upon which a permanent revenue system must be based. Both classes of considerations, the theoretical as well as the practical, will be admitted in the following comparison, which will take the form of certain propositions designed to show why the adjustment of imports for which this treatise contends is preferable, for the United States at least, to a revenue system drawn after the English model

First. The proposed programme confines the principle of taxing incomes at their source to its legitimate and reasonable use. The importance of this administrative principle cannot be overestimated, but it may be questioned if the use made of it by the English income tax is quite honest in its purpose or fair in its results. Is it quite honest, for example, for a government to keep back part of what it has promised to pay a pensioner, an annuitant, or the holder of public obligations? Is it reasonable to tax public salaries when the result of such a tax is to increase the expense of administration without increasing by one penny the clear income to the government? Can a man who knows how contracts are drawn between debtors and creditors be convinced that equity is the result of attempting to tax a money-lender through the agency of the borrower? * Can it be denied that the application of the principle of "tapping" incomes at their source to incomes which, unfortunately for their recipients, are recorded, while permitting other incomes to pay on the basis of self-assessment by the individual, is to perpetuate one of the worst features of the general property tax, namely, inequality of

* In the United States at least this plan of getting at mortgages has always failed, and under existing interstate credit relations one cannot hope from it for any degree of success.

assessments as between individuals? The position assumed by this treatise is that the rule of taxing incomes at their source should be reserved for the administration of the corporation tax, that is to say, for the taxation of those industries in which the State stands on the same footing with the shareholder both as regards control and profit. This gives to the rule a social dignity that it could not otherwise attain, and a significance that limits and directs its application. Under the influence of that line of reasoning which seeks to fit the corporation tax to the solution of the corporation problem the evil results which attend the opportunistic application of this principle may be easily avoided.

Second. The proposed programme avoids the necessity of defining incomes for the purpose of assessment, except in the case of corporations, where no serious difficulty presents itself. Two or three specifications will make clear the difficulty thus evaded. The English income tax allows the landlord a deduction for repairs, renewals, and insurance, thus introducing even here the complication of self-assessment. The United States income tax of 1862 as interpreted, and of 1894 as drawn, allowed a deduction equal to the rent paid by the occupier of a rented house in order to place him on an equal footing with one who owns the house he occupies. In some cases the attempt to tax the net income rather than the gross income has led to the deduction of interest payments, bank accounts, and all sorts of debit claims, a process very difficult for an honest man to carry out, to say nothing of the use made of it by one who is dishonest. Some laws go so far as to include speculative profits in taxable income. These cases are given as illustrative of the questions which arise in attempting to define income—questions which disappear when one combines in a single scheme a land tax on the value of the land, a corporation tax on the basis of net earnings, and a tax on personal incomes.

Third. The proposed programme obviates the fundamental criticism which has been urged against income taxation, namely, that income is not industrially homogeneous, and cannot therefore be accepted as the basis of uniform assessment. Legislators have in some instances endeavoured to set aside this criticism by classifying incomes according to their source and probable duration. Thus the Italian tax on movable

property, which for purpose of this illustration may be treated as an income tax, classifies incomes and assesses each class on a different basis. Permanent revenue is assessed at its full value; revenue, in the attainment of which capital and labour cooperate, is assessed at six-eighths of its amount; revenue arising from labour at five-eighths of the amount, and the income of public officials at four-eighths of its amount* This classification, or something like it, must approve itself to the theorist, for it recognises the difficulty inherent in accepting income as the basis of a general assessment, but it is inadequate, and any adequate classification would probably result in a very complicated system.

The fact that the classification of incomes adopted in England is purely administrative does not mean that the criticism under consideration has never been raised by English statesmen. On the contrary, the injustice of assessing incomes of different sorts at the same amount, and the inexpediency of taxing capital under the guise of income, as is done by the English system, has been the subject of much discussion. In 1852 a parliamentary committee appointed to consider this subject adjourned without a recommendation. In 1861 another committee acknowledged the criticism, but confessed "that no plan had been proposed to them which affords a practicable and equitable readjustment of the income tax, and that the objections urged against it were objections to its nature and essence rather than to the peculiar shape which had been given to it."† An attempt by Disraeli [Lord Beaconsfield] to introduce a differential tax was not successful. Perhaps Mr Gladstone expressed the controlling sentiment of the country when he said: "Mr. Pitt and Sir Robert Peel have both considered this question [that is to say, the theory of differentials applied to the income tax] and have both left the tax as a uniform tax, not indeed as the image of perfection in our fiscal system, but as that form on which, as wise, prudent, and practical men, they found it necessary to take their stand"‡ The difficulty is inherent in the system.

* Cf. Bastable, *Public Finance*, pp. 429, 430.

† Quoted from Palgrave's *Dictionary of Political Economy*, Vol. II, p. 377, not from the committee report.

‡ Quoted from Palgrave's *Dictionary*

Fourth. The fourth reason for accepting the proposed programme of revenue reform is pertinent only to the United States. Under the restrictions imposed by the Federal Constitution the Federal Government cannot levy an income tax, while under the peculiar assignment of public functions to the States an income tax with even a minimum rate would bring in more money than the States could judiciously expend; it is therefore essential that the revenue system pertinent to the needs of the American State should classify the sources of revenue and exercise great care in assigning to each grade of government its appropriate source. This touches upon a topic that is made the subject of discussion in the following chapter; it is only necessary to observe, as bearing upon this comparison between a revenue system drawn after the model of the English income tax, and one that incorporates the land tax, the corporation tax, and the tax on personal incomes, that a general income tax does not easily lend itself to the segregation of revenue sources.

We cannot bring this discussion to a close without acknowledging that the general argument contained in this treatise is in one particular inconsistent with itself. The theory of progressive taxation has received formal approval and yet but slight opportunity has been provided for its application. Only in the case of corporation taxes has it been proposed to adjust the rate on a progressive basis, and this, it will be noticed, does not necessarily secure from individuals progressive payments. The apology for this inconsistency is easily presented. The revenue system towards which our analysis points may be adjusted to the principle of progressive payments as easily as any other, but it would have introduced unnecessary confusion had the claims of this principle been recognised at every point in constructive analysis. Moreover, the first step in revenue reform must be to simplify tax laws, to eradicate duplication of tax levies, and to put an end to tax evasions; and it has seemed best to confine the investigation to this first step in revenue reform rather than indulge in refinements of analysis that can have no practical importance except upon the assumption of a justly organized and successfully administered revenue system. Another thought may be suggested. There is a wide difference between adjusting a scheme of taxation to a programme of

social and industrial reform and making use of the machinery of taxation to correct abuses in an unreformed industrial organization. The former this treatise has endeavoured to hold in mind, the latter it has refused to countenance; and it was not desired to give support to the advocates of progressive payments who regard taxation as a means of social reconstruction, as might perhaps have been the case had even the legitimate claim of progressive payments been acknowledged in connection with this administrative analysis of taxation. No book which any one is likely to read **can exhaust the Science of Finance.**

CHAPTER VI.

SUGGESTIONS FOR A REVENUE SYSTEM.

SOME GENERAL CONSIDERATIONS.

ASSIGNMENT OF SOURCES OF REVENUE TO THE FEDERAL GOVERNMENT.

- (1) Foreign Commerce and Federal Taxation.
- (2) Inland Commerce and Federal Taxation.
- (3) Excise Duties as a Federal Tax
- (4) Other Possible Sources of Federal Revenue.

ASSIGNMENT OF SOURCES OF REVENUE TO STATE AND LOCAL GOVERNMENTS

- (1) Sources of State Revenue
- (2) Sources of Local Revenue
- (3) Assignment of Tax on Inheritances and Professional Incomes.

ADMINISTRATIVE QUESTIONS SUGGESTED BY THIS SYSTEM.

- (1) Separation of State and Interstate Commerce
 - (a) *On the Basis of Gross Earnings*
 - (b) *On the Basis of Net Earnings*
- (2) Organization for Administering State and Local Taxes.
 - (a) *Interstate Organization.*
 - (b) *Organization within the State*
 - (c) *Organization within the Municipality.*

WHILE many questions which present themselves to the financier have not been considered in the foregoing pages, it is believed that all of the important fiscal principles have been made the subject of discussion. This being the case, we are prepared to enter upon the task of constructive analysis. In suggesting a revenue system pertinent to the present conditions of the American people it is not claimed that the plan outlined is the only one worthy of consideration. Principles are inexorable, but plans and programmes are matters of ingenuity. One who has proceeded far enough in his study to understand the nature of fiscal adjustments must recognise that there are several ways in which the revenue system of this country could be remodelled with advantage;

and it will add something to the liberty with which we proceed in this chapter, which is devoted to the construction of a revenue system, to say that its object is pedagogical rather than advisory. The best possible review of complicated principles is to undertake to apply them, and such is primarily the purpose of the analysis which follows. It is possible, also, that new light may be shed upon the character of these principles by endeavouring to weld them into a system, for then will their relations to each other be more clearly exposed.

73. Some General Considerations—It may be well at the outset to remind ourselves of certain general conclusions already arrived at.

From a consideration of the requirements of a good revenue system it was learned that the income placed at the disposal of the State must be moderate and not excessive; that it must be elastic for a sovereign government and certain for a local government; and that it must conform to the political organization of the State to which it applies.

From the analysis of the nature of the tax the legal requirements of a tax were fully explained, and a practical interpretation given to the phrase "justice and equity in matters of tax", and this latter point was further elucidated in the chapter upon "Apportionment of Taxes."

From the chapter upon the "Classification of Taxes" the nature of each kind of tax was made clear, as also the relation of the several classes of taxes to each other, and the kind of taxes that could be used together in a general revenue system was determined.

From an investigation into the general results of taxes the idea that a tax should be equitable in payment as between citizens was expanded so as to include the thought that a just system of taxation must conform to social needs, and certain conclusions were arrived at respecting the manner in which taxes work by which the financier was excused from some of the most troublesome claims that have been made respecting equity in taxation from the individual point of view.

From the chapter just closed the peculiar character of the several classes of taxes that must be employed in framing a revenue system was yet more clearly presented.

In our discussion of the general property tax reasons were presented why separate sources of revenue should be assigned to the commonwealths and the minor civil divisions. It may now be remarked that this conclusion was a special application of the general principle of segregated sources of revenue, a principle which may be profitably applied, with more or less strictness, as between all the grades of government that together make up the American State. The first step, therefore, in formulating a general revenue system is to assign sources of revenue to the several grades of government.

An appropriate assignment of revenue sources will depend in large measure upon the amount of revenue which any particular grade of government may require as compared with the other centres of public authority. Referring again to the census figures of 1890, it appears that the aggregate of public income for that year amounted to \$979,590,915, divided between the four grades of government as follows

| Grade of Government. | Amount \$ | Percentage of the Aggregate | Per Capita Income \$ |
|-------------------------------|--------------|-----------------------------|----------------------|
| Federal government..... | 400,272,582* | 40.8 | 6.39 |
| State governments | 116,156,640 | 11.8 | 1.86 |
| Minor civil divisions | 133,525,493 | 13.5 | 3.01 |
| Municipalities | 329,635,200† | 33.9 | 18.01 |

By comparing the amounts required by each grade of government with the aggregate governmental expenditure it appears that the Federal Government covers into its treasury 40.8 per cent of the aggregate, while the State governments or commonwealths cover into their treasuries 11.8 per cent, the minor civil divisions 13.5 per cent, and the municipalities 33.9 per cent. So far as the governmental functions are concerned it is the theory of American law that the States were originally the residence of all sovereign authority, and that they now retain all authority not delegated to the Federal Government. This being the case, it seems at first a little strange that the States require only 11.8 per cent of the aggregate of moneys collected; but this is

* Exclusive of postoffice.

† Net income.

explained by the fact that, since the adoption of the Federal Constitution, there has been a decided shifting of political influence. The Federal Government has grown in importance because it is the representative of the national idea, while the local governments have grown because they carry with them the industrial development of the nation. At the present time the commonwealths are practically, though not legally, administrative units subordinate in every essential particular to the highest necessities of the Federal State. It is true that they are the source of all authority for local governments, that is to say, for the municipalities and the minor civil divisions. Inasmuch, however, as this authority is commonly expressed by them through general laws rather than by special charters, and inasmuch as it is the political theory of the English-speaking people to bring the exercise of political power as closely as possible to the people upon whom it is exercised, the commonwealths do not take a very active part in the business of administration. We find, then, in an analysis of the political situation a reason why the States need so small a proportion of the aggregate of public income, and, as it is a reason that seems to lie in the nature of the case, its observed result may be accepted as indicating a more or less permanent condition, which a financier should recognise in making his assignments of sources of revenue.

Referring again to the table given above, it appears that the income of the Federal Government calls for a per capita payment of \$6.39, that of the State governments of \$1.86, of the minor civil divisions of \$3.01, and of the municipalities of \$18.01. The per capita payment for the support of government of all grades is \$15.64. This fact also may have some bearing upon the question of the proper source from which the revenue of the several grades of government should be drawn, and must be held in mind throughout the analysis. It would seem, for example, since the payments are the greatest where the social relations are most intense—that is to say, in the cities—that there would be some propriety in opening up to the cities as a peculiar source of revenue that fund of values which the growth and the life of the cities have caused to be created. Reference is here made to all forms of municipal monopolies.

In addition to the above suggestions, which are general

in their application, perhaps the controlling consideration in the assignment of sources of revenue is found in the public functions which each grade of government performs. For the presentation of this thought we shall inquire directly respecting the source of revenue pertinent to the Federal, the State and the local governments.

74. Assignment of Revenue to the Federal Government.—The Federal Government stands for nationality. It represents the sovereignty of the people. It has exclusive jurisdiction over international controversies and is intrusted with the power of declaring war and of concluding peace. The fiscal needs of such a government are easily understood. Certainty of revenue and elasticity of revenue are the marks of a fiscal system adjusted to the needs of a sovereign State. Certainty of revenue is required that the government may carry itself with dignity and perform its customary duties with economy and ease, elasticity of revenue is required that it may at all times be prepared for exigencies. The former of these demands is one which a federal government recognises in common with all grades of government, although it is relatively more important for a sovereign State than for an administrative district, the latter, however, is peculiar to an imperial government, since this is the only government exposed to the possibility of serious fiscal exigencies.

(1) FOREIGN COMMERCE AND FEDERAL TAXATION.—Understanding, then, the needs of the Federal Government, both as regards the relative amount to be raised and the peculiar requirements due to the political responsibilities which it has assumed, what funds should be set aside as the source of Federal income? In view of the fact that current income must accrue from current industry, it is natural to inquire what industry, if any, is placed under the special guardianship or direction of the Federal Government, for it is to such an industry that Congress would naturally turn for revenue.

Other things being equal, a government should select for purpose of taxation those industries with which it holds some fundamental or constitutional relation. This is justified, if in no other way, on the ground of economy; for all the information gathered, and much of the machinery set in motion for the discharge of political and administrative responsibilities may be used by the financier in the framing and

executing of tax laws. The application of this generalization to the Federal Government is clear. According to the Constitution Congress is intrusted with absolute control over foreign and interstate commerce. This was not the result of an accident or of a compromise. Says Webster "The entire purpose for which the delegates assembled at Annapolis was to devise means for the uniform regulation of trade." Says Chief Justice Marshall. "The power over commerce, including navigation, was one of the primary objects for which the people of America adopted their government." It was the necessity of a clear revenue, rather than a revenue dependent upon the whims of the several States, which caused the early statesmen to demand for Congress comprehensive fiscal powers, and it was the necessity for uniform conditions for the development of a healthful commerce, and the establishment of an efficient industry upon the basis of that commerce, that led them to request from the States the concession that the Federal Government should have the exclusive right to levy import duties.

The reasoning involved in this demand may be best presented by an illustration. Were the State of New York, which enters more than one-half of the foreign goods brought into the United States, allowed to impose a duty upon their importation, it would result in placing the citizens of other States under tribute to the State of New York. Manifestly this would be unfair to the inland States, and could not be allowed in a justly organized Federal State. Moreover, were it allowed other States would undoubtedly establish reprisals against the State of New York, and the result would be the destruction of that commercial unity without which the industries of a people cannot flourish. Nor would the evil thus engendered be limited to an arrested commercial development. Commercial unity being thus rendered impossible, the spirit of solidarity, which is essential to the existence of a nation, would be impossible of realization. It thus appears that the people of this country are saved not alone from an embarrassing confusion of revenue laws, but from political disaster as well, by the fact that the Constitution grants to Congress the exclusive right to levy import duties.

(2) INLAND COMMERCE AND FEDERAL TAXATION.—The

political and industrial considerations which, at the time the Constitution was adopted, justified the Federal Government in assuming exclusive jurisdiction over foreign trade are equally valid when applied to inland commerce. The influence of railways in creating organic unity out of what might otherwise be a lifeless union needs no elucidation, nor is it necessary to explain how that influence would be embarrassed in its workings, if not indeed deprived of a large share of its efficiency, were interstate commerce exposed to the attacks of the revenue laws of the several States. It is not possible to express clearly and concisely the position assumed by the courts upon this point, but throughout their numerous, and at times conflicting, opinions there seems to run the purpose of preserving the unity of inland commerce. This purpose is recognised in the decisions of cases that have arisen respecting the taxation by States of the gross earnings of railways, but is more manifest in the decisions rendered upon the general question of railway control. In 1886 the Supreme Court of the United States affirmed in positive language the principle that the Constitution gave to Congress exclusive jurisdiction over interstate commerce, and presented the reasons why the application of this principle to railway traffic was of especial importance. Upon this point the language of the court was as follows:

"It cannot be too strongly insisted upon that the right of continuous transportation from one end of the country to the other is essential in modern times to that freedom of commerce from the restraints which the States might choose to impose upon it that the commerce clause was intended to secure. This clause, giving to Congress the power to regulate commerce among the States, as this court has said before, was among the most important of the subjects which promoted the formation of the Constitution . . . That this species of regulation is one which must be, if established at all, of a general and national character, cannot be safely and wisely remitted to local rules and local regulations, we think is clear from what has already been said, and if it be a regulation of commerce [that is to say, the law under consideration] . . . it must be of that national character, and the regulations can only approximately exist by general rules and principles, which demand that it should be done by the

Congress of the United States, under the commerce clause of the Constitution”^{*}

It will be remembered that this decision, which separated interstate from State traffic and limited the jurisdiction of the Federal Government and the State governments accordingly, was the occasion of the establishment of the Interstate Commerce Commission, by which the duty of exercising control over the administration of interstate traffic was assumed by Congress. It is not too strong an affirmation to say that the necessity of a uniform control over interstate traffic was as vital to the interests of the people in 1887 as was the necessity of uniform control over foreign trade in 1789. Financially there was this difference in the two periods named: in 1789 the Federal Government was in pressing need of an assured revenue, and turned naturally to that phase of industrial activity with which, for other reasons, it came into contact; in 1887 the government was in the enjoyment of ample revenue, and the thought of making inland commerce as well as foreign commerce a source of income did not present itself. But the fundamental relation is the same in the two cases: the constitutional provision is the same; the significance of uniformity is the same; and it requires no great insight to warrant the assertion that, when the necessity shall arise, interstate commerce as well as foreign trade will come to be a source of revenue for the Federal Government. The occasion for such a step may be the rise of some fiscal exigency, or it may be the purpose of the government to carry through a fiscal reform; but whatever the occasion the result is sure to arrive. The logic of the situation reserves the control and taxation of commerce to the government which represents the sovereignty and unity of the people, and the fact that revenue can be so easily increased by the taxation of interstate traffic renders it highly probable that such a step will not be long delayed.

(3) EXCISE DUTIES AS A FEDERAL TAX.—Thus far our inquiry respecting the source of revenue pertinent to the Federal Government has been under the guidance of the considerations that the dignity of the State demands certainty of revenue, and that it is wise for a government to

^{*} Quoted from Dos Passos, *The Interstate Commerce Act*, pp. 5, 6, and 7.

select for the purpose of taxation that branch of industry with which it has administrative dealings. It will be remembered, however, that elasticity as well as certainty is essential for the revenue system of a sovereign State. A system that rests on commerce cannot easily respond to the fluctuating demands of government. A great exigency, as, for example, the advent of a war, is sure to embarrass commerce and curtail income, and any attempt to increase revenue by raising the rate will, under such circumstances, be sure to intensify the embarrassment and decrease the income. In 1812, for example, the rates on imports were doubled, but the revenue did not respond to the call thus made upon it. How, then, it may be asked, can an elastic or responsive revenue be established for the Federal Government? This question presents a most important problem.

The solution of this problem, so far as it has been solved, is found in that series of acts by which the Internal Revenue System was established. The necessity of a revenue not dependent on the exigencies of foreign commerce was made clear by the experience of the treasury during the years 1861 and 1862. This is no place to narrate the financial history of those years, or to expose the mistaken theory upon which Congress proceeded in formulating a financial policy for the management of the war. The fact is the early attempts of the treasury to command the wealth of the nation were failures, and it was only in proportion as internal revenue became productive that public finances were brought under control. It may have been this experience which demonstrated to Congress the importance of flexible revenue, and which led to the continuance of internal taxes after the occasion which called them into existence had passed away. But whatever the reason, the machinery of a system of excise duties has been maintained and kept in operation since the close of the war, and the government is, on this account, in a position to carry through a sound fiscal policy in the face of any exigency likely to arise. The theory of war-financiering pertains to that part of the Science of Finance that deals with the use of public credit, but it must be evident at a glance that it is the part of wisdom, when making provision for current revenue, to hold in mind the possible necessity of using the revenue machinery of ordinary times.

as the basis of exigency financierings. This is the justification, and the only justification, for maintaining internal duties as a source of Federal revenue in time of peace. It is not claimed that the rules by which the system is administered have been formulated in view of the peculiar service which it is the function of that system to render. On the contrary, there is direct evidence in the rates imposed on those processes of manufacture retained for taxation that the fiscal significance of the system is not appreciated. But the only point which it is now necessary to recognise is that a sound reason exists for granting to the Federal Government the exclusive right to appeal to excise duties as a source of revenue.

The propriety of granting the Federal Government exclusive appeal to excise duties is further supported by a consideration of the confusion that would follow should the States undertake to tax the process of manufacture. Since the development of railway communication there no longer exists a local or restricted market. It requires but a slight difference in price to call goods from one part of the country to another. This being the case, it is essential to the preservation of a healthful and equitably distributed industry that the conditions of manufacture should be, so far as possible, the same in all parts of the country. At least no artificial differences should be established, as would be the case should each State undertake to levy excise duties. The point is that uniformity of excise laws is essential, and the only means of attaining this uniformity under the constitutional provisions which exist is for the Federal Government to assume exclusive control over their administration.

(4) OTHER POSSIBLE SOURCES OF FEDERAL REVENUE.—It may be asked why Congress cannot make use of direct taxation, as provided in the Constitution, to secure elasticity in its general revenue system. In reply to this question it may be said that this means of raising revenue in time of emergency amounts to little more than the old method of requisitions practised during the period of the Confederation, with the reservation to the Federal Government of the right to enter the State and collect the tax should the State fail to meet the demands made upon it. It may not be final against such a scheme that it does not harmonize with the

policy of segregated sources of revenue, although it is evident that, for one who assumes the standpoint of this treatise, the Federal Government may wisely refrain from entering upon that domain of taxation which pertains to the States and the local governments. A more pertinent argument against the use of direct taxation by the Federal Government is the experience of Congress upon the two occasions when it was attempted to control a fiscal exigency by opening up this source of revenue. On the occasion of the wars of 1812 and 1861 appeal was made to direct taxation, but in neither instance did the money come into the treasury in time to do much good. The effect of the tax upon the imaginations of money lenders was very slight, and, in view of the large amounts which proved to be necessary, it may be doubted if this source of revenue could have been of much use without jeopardizing the political integrity of local finances. And, finally, as against the use of direct taxation by the Federal Government reference must be made to the constitutional rule for its apportionment. According to the Constitution this tax must be apportioned to the States on the basis of Federal population. Whatever may be said in justification of this rule at the time the Constitution was adopted, its employment at the present time would result in an unequal assignment of a common duty between the rich and the poor States. Nor would it be possible for an income tax to perform the service in the general revenue system which we have assigned to excise duties. For an income tax being a direct tax cannot be assessed to individuals except it first be apportioned to the States on the basis of population, a procedure which would result in gross inequalities as between the citizens of the several States. Moreover, an income tax would quickly reach the limit of its productivity except it apply to corporation and business incomes, and this, besides blurring the real significance of corporation and business taxes, would, like forced requisitions upon the States, result in obliterating the distinction between the Federal and the State domains of taxation.

We may, then, conclude that the revenues that should be assigned to the exclusive use of the Federal Government are such as arise from the taxation of imports, the taxation of interstate commerce, and the taxation of the process of

manufactures—a conclusion which, we trust, will be strengthened when the relation of the Federal revenue system to the general revenue system in the scheme now being unfolded is more fully appreciated. These three sources of revenue, supplemented by a judicious use of public credit, are adequate to all fiscal needs, both ordinary and extraordinary, that can present themselves to the Federal Government.

75. Assignment of Sources of Revenue to State and Local Governments —Not less clearly do the peculiar services performed by the State and municipal governments, and the form of property in rural districts, indicate the source of revenue that should be assigned to them.

(1) **SOURCES OF STATE REVENUE.**—The States, it will be remembered, assume no responsibility for international affairs, and in interstate complications their liberty extends no farther than to be recognised as a party in a case. The Federal Government could not permit serious diplomatic correspondence to be carried on between the States, for this would be equivalent to the recognition of the right of a State to sever friendly relations with a sister State, which would be equivalent to the destruction of the Union itself. This being the case, the States are never exposed to an emergency and do not need that quick response from revenue so essential to the efficiency of the Federal Government. They are, therefore, excused from the consideration of one of the most difficult problems in framing a revenue system.

Approaching the question upon its positive side the duties of the States are primarily legislative in character. They give to the minor civil divisions and the municipalities their forms of government and clothe them with their administrative powers; they provide laws of industrial association and grant charters to industrial corporations; they are the guardians of all wealth that in any way accrues to citizens in their collective capacity; and, finally, they are called upon to administer such public institutions as do not naturally pertain to the local governments. If, now, one place by the side of this cursory characterization of governmental duties imposed upon the States the analysis which led to the selection of industries for special taxation (municipal monopolies

alone being excepted)* he will be impressed with the fact that the special or corporation taxes referred to naturally pertain to the State as a peculiar, if not an exclusive, source of revenue. The vast majority of industrial corporations are the creatures of the States, and it is to the State governments that the people look for their regulation and control. With few exceptions, natural monopolies, also, such as mines, forests, water-supply for irrigation, and the like, do not exert a commercial influence beyond the boundaries of the State in which they are situated, and should a royalty be imposed upon their earnings it should accrue to the government which represents the people to whom they rightfully belong. If, now, the State governments can secure adequate revenue from special taxes on corporations and on natural monopolies the fact that they are charged with peculiar duties in connection with corporations, and stand for the proprietary interest of the people in the original values of the soil and the social increment of labour, provides ample reason why this source of revenue should be placed at their disposal.

In view of the ever-changing opinions of legislatures respecting the taxation of the localized property or agencies of corporations, it may be well to express the view entertained by this treatise in an explicit manner. The assignment of the corporation tax to the State means that the buildings and right of way of a railway, for example, should be exempt from local taxation; and if it be admitted, as has been argued, that net revenue to railways should be the basis of their taxation, and that the business from which this net revenue accrues holds no necessary relation to the value of the property distributed along the line of road, the justice of this plan becomes apparent. The earnings of the railways accrue (interstate commerce being dropped from view) on the general business furnished by the State, their payment for the support of the government, therefore, should be to the State, and not to the localities. The same argument applies to an insurance company located in a city, or to an unusually profitable mine located in a county. The industries are localized, while the business that gives them value is diffused, nor can there, in the cases named, be any offset on account of

* *Vide* § 70, (1).

similar businesses situated in other cities or counties Does it not, then, appear just that what they pay for the support of government should be paid to the government of the people whose patronage gives rise to the value in question ? In some cases this patronage may be interstate, but since interstate commerce is by the scheme under consideration assigned to the Federal Government, this fact suggests no criticism upon the plan We conclude, then, in view of the peculiar duties imposed upon a State, and because of the nature of corporations and natural monopolies, that all special and corporation taxes should be assigned to the State as an exclusive source of revenue Of inheritance and income taxes we shall speak later

(2) SOURCES OF LOCAL REVENUE—If localities are precluded from taxing corporate property, though it lie within their territorial jurisdiction, the States must in turn be excluded from the domain of local taxation. And it lies next in our analysis to inquire what source of revenue remains for local governments. This discussion will distinguish between municipalities on the one hand, and the counties, townships, school districts, and other units of local administration on the other. Addressing our attention first to rural local governments, it may be remarked that no source of revenue peculiarly fitted to governments of this grade is suggested by a consideration of the class of duties with which they are charged. The functions which they perform pertain to the maintenance of local courts and an efficient constabulary, to the construction and maintenance of highways and bridges, to the provision for a common-school education, and other services of a like nature These functions, it will be observed, are primarily administrative, and do not rest for their easy performance upon an exclusive appeal to any particular source of revenue Thus being the case, the selection of a source of revenue must rest upon some other consideration, and that which appeals most naturally for approval is found in the nature of the industries with which as a rule country life is concerned. The industry of the country is agriculture, and it is a significant fact in the choice of a revenue system for the minor civil divisions that agriculture is represented by visible property In considering the general property tax it was learned that the only difficulty to its successful adminis-

tration when confined to rural property arose from the fact that local property was assessed by local officers for State purposes. The State, however, being provided with a source of revenue peculiar to itself, as is proposed by the plan under consideration, and the minor civil divisions being granted exclusive right to levy taxes upon real property lying within their respective jurisdictions, there is no reason why the machinery of the general property tax as it now stands cannot satisfy all the legitimate demands of rural financing.* In deliberating upon the above suggestion the student must remember that justice in taxation does not demand the assessment of all industries, and that the exemption of mortgages from taxation is no detriment to the borrower of money. The conclusion is that the property tax upon rural property in the form of the land tax should be assigned to the exclusive use of rural local governments.

Coming now to urban local governments, the problem of the source of revenue is somewhat more complicated; for, in addition to the ordinary functions of local administration which cities have in common with country districts, they are charged with many special functions growing out of the necessity of collective services and of the evils which spring from a congested population. In the first place, it may be remarked that the relation of the municipality to the State is practically the same as that of the minor civil divisions, and that, on this account, an analogous conclusion may be arrived at with regard to the taxation of landed values. The general property tax may be retained by the municipality in so far as visible property is concerned. In administering the real estate tax, however, it may be proper for the municipality to adopt a different set of principles from those that are pertinent to the rural governments.

The selection of further sources of revenue for municipalities depends upon the peculiar duties imposed upon them. As the State assumes the solution of the problem of State monopolies, so the municipality must assume the solution of

* It will be observed that the text fails to distinguish between the county, and other forms of local administration, which is equivalent to saying that the county is the proper unit of local authority. This is done rather for the purpose of facilitating discussion than of expressing an opinion on so important a question of local administration.

the problem of municipal monopolies, and this fact in the one case as in the other suggests the second source of revenue to which municipalities may rightly appeal. The present tendency of forcing municipal monopolies to contribute largely to municipal expenditures, either by special taxation or through public ownership, is wholly to be commended, for it lies in the nature of the case. Besides the necessity of some public control over water companies, lighting companies, and street railways, the policy here outlined finds support in the fact that it is a means of giving back to the people part of the earnings of the property rendered valuable by the fact that the city exists. The situation is as follows. The growth of the city occasions unusual expenditures, the growth of the city also creates unusual values. Why should not the values which the city creates go to bear the expenses which the city occasions? There appears then a double reason for assigning municipal monopolies as a special source of revenue to the municipal treasury.

(3) ASSIGNMENT OF TAX ON INHERITANCES AND PROFESSIONAL INCOMES.—The fiscal system thus presented makes use of all the sources of revenue which the foregoing analysis and classification of taxes shows to be desirable, with the exception of the taxation of inheritances and professional incomes. It is a little difficult to say what grade of government should receive the proceeds of succession duties. The Federal Government would be excluded because, under the rule imposed by the Constitution, it cannot justly make use of direct taxation. As between the State and local governments it might perhaps be necessary, in strict logic, to inquire respecting the origin of the property, and to grant the proceeds of the succession duty to that government which gave protection to the business during the accumulation of the property, or which stands for the citizens whose business activity rendered the accumulation of the property possible. Such a suggestion is scarcely pertinent, however, because of the many embarrassments that would arise in its application. All interests would be fairly well satisfied were succession duties assigned to the State governments with, however, the understanding that the States were to use the proceeds of these taxes, not for the purpose of paying current ordinary expenses, but for the rendering of

some particular service of interest to all citizens. Why, for example, should not the States assign the proceeds of succession duties to the service of education, and especially to the service of higher university education?

The reason why professional incomes demand peculiar treatment is that there is no property or commercial organization by which the lawyer, the physician, and the merchant are represented, and the price of their services are not equalized by commercial forces. As property owners and as consumers they are called upon to pay something for the support of government, but their peculiar income is unaffected by the plan of taxation here outlined. There is no means of securing payment from this class of incomes except through the imposition of a tax upon the practice of the several professions regarded as distinct classes in the community. The administrative principle which underlies the revenue system to which this treatise grants approval is that the government must address itself to the industrial property, the industrial process, or to the industrial organization for payments, rather than to the individual; and it seems wise to proceed upon the assumption that lawyers, physicians, and merchants can organize themselves into professional guilds and that the government should address its demands for money to the guild or association rather than to individuals. This point, however, was adequately considered in the previous chapter. For the present we may say that the revenue accruing from personal incomes is a revenue that pertains to the local government in which the business or profession has its location. It may then be assigned as a municipal revenue.

The statement that follows presents in a concise form the conclusions at which our analysis has arrived. Whether or not one approve this selection of the sources of income and their assignment to the several grades of government, the scheme at least has the merit of presenting a comprehensive programme of financial reform. It serves as an object-lesson of what is meant by segregation of revenue sources.

**ANALYSIS OF POSSIBLE TAXES, DESIGNATION OF APPROVED TAXES,
AND ASSIGNMENT OF APPROVED TAXES TO THE SEVERAL GRADES
OF GOVERNMENT IN THE UNITED STATES**

| Possible Taxes. | Taxes Approved | Assignment of Approved Taxes. |
|----------------------------------|-------------------|---|
| <i>Taxes on Income</i> | | |
| a. Income from services. | Approv'd | Municipal governments. |
| b. Income from property. | | |
| c. Income of property. | Approv'd | State governments. |
| <i>Taxes on Property</i> | | |
| a. Property in person. | | |
| b. Property in land | Approv'd | { Municipal governments and minor civil divisions. |
| c. Property in capital. | | |
| d. Property in wealth for use | | |
| <i>Taxes on Business.</i> | | |
| a. License tax. | Approv'd | { Municipal and town government, but administered for police supervision |
| b. Franchise tax. | Approv'd | Municipal government. |
| c. Corporation tax | Approv'd | { State governments, and, in case of interstate commerce, the federal government. |
| d. Excise duties | Approv'd | Federal government. |
| e. Customs duties. | Approv'd | Federal government. |

76. Administrative Questions Suggested by this System.—It is not enough, in order to insure the acceptance of a proposed revenue system, to show that it reflects a consistent fiscal theory; for one is always at liberty to ask if the system can be easily administered, and if the means necessary for its administration conform to the healthful trend of social evolution. This being the case, it now becomes our task to inquire what changes in administration or what steps in political organization are necessary to insure the successful working of the programme briefly outlined. Several questions present themselves when looking at the matter from this point of view

(1) **SEPARATION OF STATE AND INTERSTATE COMMERCE.**—The attention of the student has doubtless been arrested by the classification of inland traffic as State and interstate traffic, the net earnings upon the former being assigned to the State for purpose of taxation, while the Federal Government enjoys the exclusive right to impose taxes upon the latter. Can this classification be followed in practice?

In the first place it may be remarked that this distinction is not an arbitrary one, but exists in the organization of the State itself. All interstate traffic is placed by fundamental law under the jurisdiction of Congress, while infra-state traffic is reserved to the jurisdiction of the States. Not only is this distinction clearly expressed in the Constitution, but it has been made the basis of a long line of consistent decisions by the courts for more than a hundred years. It is thus evident that the financier who seeks to make use of this classification in a fiscal scheme does not enter upon untrodden ground. On the contrary, he will find many of the terms and phrases which he must employ authoritatively defined in established law, while the general principles underlying his task, as well as the reasoning involved, have already been expressed.

Another fact may be noticed in this connection, which, while no more important in itself, has perhaps a more direct bearing upon the question in hand. Railway legislation in the United States (for the purpose of specific statement other forms of interstate commerce are dropped from view) has adjusted itself to this distinction between State and interstate commerce, the former being placed under the jurisdiction of State railway commissions, while the latter is consigned to the jurisdiction of a Federal commission. These two sets of agencies are complementary to each other, and neither can hope for the highest success without the cooperation of the other. To this end it is incumbent upon the commissions that for the purpose of administration they work out the line of demarcation between State and interstate traffic, which the fiscal scheme here presented accepts as separating the local from the Federal taxation of inland commerce. Now it is a most significant fact, for the purpose we have in view, that the character of the traffic, and not the localization of the appliances by which passengers and freight are carried, is accepted as the basis of the distinction between State and interstate traffic, since it is the earnings of commerce, and not commercial appliances, which, according to the thesis here maintained, must be made the object of taxation.

The suggestion that interstate commerce should be assigned to the Federal Government and infra-state commerce to the States as a source of revenue through taxation not only conforms to the conception that underlies fundamental

law, but it makes use of a distinction that must be worked out in a branch of public administration with which finances have nothing to do. In this the scheme conforms to what has been termed administrative economy. The expense incident to the classification of commerce is one that must be incurred in order to render the control of railways through commissions effective, why should not the fiscal system be so adjusted as to make use of this expenditure in connection with the operations of the Treasury?

The separation of traffic into State and interstate traffic is not in itself a difficult task, although great care must be exercised in selecting a proper basis upon which to proceed. A separation upon the basis of tonnage, or of ton-mileage, would be of relatively slight importance. It could answer none of those questions that arise respecting the probable effect of a change in rates, which is the significant thing for a Railway Commission to consider, nor could it serve as a basis of assessment in a financial system that accepts earnings rather than the volume of traffic as the proper object of taxation. In some way the rate received upon the traffic carried must enter into the computation. The classification must be more than a territorial assignment of tonnage or it will not be worth the making.

The commercial factor which represents both the volume of traffic and the rate at which it is carried is earnings, and the administrative problem that presents itself pertains to the separation of earnings according as it accrues upon State or interstate commerce. The distinction between "gross" and "net" earnings has already been explained, and it will be remembered that the net earnings of a corporation are, theoretically, the more appropriate basis of assessment. It is also true that net earnings are of relatively greater importance to Railway Commissions in the discharge of their peculiar duties. Inasmuch, however, as gross earnings must be made the basis of net earnings, and since there are many who favour the adjustment of corporation taxes to the former rather than the latter, the analysis that follows will consider the two items separately. The thought, also, may be interjected at this point that the common objection of the courts to the acceptance of gross earnings as the basis of State taxes, namely, that by means of it the States tax

interstate commerce, would be overcome by the plan here outlined, for it would result from this plan that each grade of government would be restricted to the traffic that pertains to it by the Constitution. It is possible, therefore, should the task of working out the programme here outlined be actually undertaken, that practical considerations would lead to the acceptance of gross earnings rather than of net earnings as the basis of assessment.

(a) *On the Basis of Gross Earnings*—Accepting gross earnings as the amount of income resulting from the amount of traffic multiplied into the rate charged for transportation, no allowance or deduction being made for expenditures incident to operation, it is clear that its separation into State and interstate earnings must conform to the respective amounts of the two sorts of traffic and to the rates at which each is carried. Were these rates uniform, the earnings would be in proportion to ton-mileage; but the rates are not, and from the nature of the case cannot be, uniform. They vary for different lines and for different parts of the same line. They are influenced by the kind of goods carried, the conditions under which they are carried, and for the distance carried. Special rates, also, for special commodities or selected territories are a familiar and probably a permanent feature of railway transportation. A classification on the basis of tonnage, mileage, ton-mileage, or indeed any other physical attribute of commerce, must be inadequate.

Or were it true that interstate traffic is always inter-line traffic, while State traffic is confined to single lines of road, the problem would be easy of solution. This is true because it is necessary for the railways to separate these two kinds of traffic in order to settle accounts between themselves. But the assumption does not conform to the facts in the case, and an assessment of taxes on the basis of such a classification would be devoid of any very definite meaning. There is, however, in this second assumption a most fruitful suggestion. If inter-line accounting is adequate to settle fairly the accounts between railways that unite for through or long-distance transportation, it is only necessary to organize this accounting into a Federal system, and to so extend it as to include interstate traffic carried on single lines, in order to secure all that is necessary for the purpose of the financier. In the development of

railway organization there must, sooner or later, be established a Clearing-house of Railway Accounts, and it would be highly advantageous from many points of view should the claims of a sound fiscal system and the demand for adequate public control over the business of transportation be permitted to give shape to that organization. Our conclusion is that, so far as gross earnings are concerned, no technical or theoretical difficulties stand in the way of an honest separation of State and interstate traffic.

(b) *On the Basis of Net Earnings*—The serious difficulty makes its appearance as soon as one passes from the ledger of receipts to the ledger of expenses. This is true because so large a proportion of railway expenditures are common to all classes of traffic. It is difficult to determine the cost of running a given train; how much more difficult to assign that cost to the different classes of goods carried in the train. It cannot be done, and railway accountants and railway commissioners have alike recognised that it cannot be done.

While acknowledging this to be true for the fine questions that arise in connection with public control of railways, it may yet be possible to arrive at a separation of State and interstate net railway earnings with sufficient accuracy to serve the legitimate demands of a fiscal system. It must be remembered that the interests affected are the fiscal systems of two grades of government, and that justice to individuals, either relative or absolute, is not involved. This being the case, the financier is justified in making use of rules for the classification of railway earnings, even though they are in some degree arbitrary, provided they are fairly reasonable and acceptable to the parties concerned, that is to say, to the Federal Government on the one hand and State governments on the other.*

(2) ORGANIZATION FOR ADMINISTERING STATE AND LOCAL TAXES.—The Federal Government might, by the exercise of such powers as it clearly possesses, proceed to the taxation of interstate commerce independently of any agreement or

* Should the task of separating state and interstate net earnings be undertaken, much assistance would be rendered by the "Classification of Operating Expenses" officially issued by the Interstate Commerce Commission.

understanding with the States; and were the taxation of inland commerce in a consistent and uniform manner the only point involved in the programme under consideration, our discussion might now be brought to a logical close. But there are other interests involved which demand consideration.

(a) *Interstate Organization*—We have on several occasions encountered the complaint that the fiscal laws of the State and local governments recognise double taxation by the form in which they are drawn, while in reality they encourage the citizen so to distribute his business interests as to evade all payments. This is due to the fact that business connections may extend beyond the jurisdiction of any single taxing unit. An insurance company, for example, sells policies in many States. The Federal Constitution very wisely denies a State the right of excluding the citizens of other States from transacting business within its borders. But it certainly seems just, and is entirely lawful, that the business done within a State, no matter where the location of its principal offices may be, should pay a tax upon such business. There is a very considerable class of undertakings respecting which the taxing laws are imperfect and work in an unjust manner, because there is no organization between the States for the localization of the transactions in question.

The task thus suggested of extending the fiscal organization by an interstate agreement, which shall coincide with the commercial jurisdiction of industries that traffic in two or more States, is not so difficult as it may at first blush appear. The principal evils of the present system, that is to say duplication and evasion of taxation, have already been set one side by the programme under consideration—first, by the remission of taxes on mortgages and analogous property, and second, by imposing upon the Federal Government the duty of bringing substantial uniformity into the domain of railway taxation. There remains, therefore, no very large number of troublesome industries, for it must also be held in mind that, according to the proposed fiscal system, all industries subject to the jurisdiction of commercial competition are released from taxation except as taxed through the excise laws of the Federal Government. To carry out

this task, which must of course rest upon a conscious desire on the part of the States for a uniform system of taxation of all businesses of interstate transactions, the first step would undoubtedly be the establishment of a joint bureau of statistics and accounts, resting for its authority upon State law. It is not necessary to proceed further in the direction of positive suggestions. Provided accurate information can be gathered respecting the industries under consideration, and provided such rules of bookkeeping are prescribed that earnings can be measured and localized, the unification of the tax laws, so far as the details of their levy and collection are concerned, may confidently be expected.

(b) *Organization within the State.*—Reference may be made to yet another form in which this need of organization for authoritative information shows itself, although in this instance it pertains to interests that lie within the jurisdiction of a single State. In the separation of the sources of revenue between the State and the local governments it will be remembered that natural monopolies, so conditioned as to enable them to sell their products beyond the jurisdiction of the local government within which they lie, were assigned to the States as a fit object of taxation. In some cases, however, as, for example, in a county possessing a peculiarly rich mine, this might deprive the local government of so much of its taxable property as to occasion serious embarrassment. This illustrates how at best the finances of the States will be mixed up with those of the localities; but no serious difficulty can arise on this account provided the State adopts some uniform rule for the adjustment of all similar cases. Under the circumstances described it is only necessary for the State to assign such property to the localities for taxation at a value reduced to the level of non-monopolistic property. This it can easily do, because, since it accepts the royalty accruing upon the mine as the basis of its own levy of taxes, it must maintain a statistical service adequate to determine that royalty, and the non-monopolistic value of property is what is left after deducting the capitalization of the royalty which it pays.

It seems scarcely necessary to follow out the application of this idea to all the phases of State and municipal taxation. So far as rural taxation is concerned the system of local as-

assessments in its present form is adequate. The significant fact in the suggestions here entertained is that the industrial evolution of the last fifty years has imposed on government a new series of duties, which, for want of a better phrase, may be termed the control of monopolistic industries. The conservative opinion of the nation is coming to recognise that these industries cannot be regarded as private within the historic meaning of English jurisprudence, and that they must be brought under peculiar rules of administration. On the other hand, industrial analysis has made clear the fact that the earnings of these industries are in a peculiar sense socially created, and on this account should contribute generously for the support of government. This is the significance of the corporation tax. Putting these facts side by side, it follows that the control of corporations and the taxation of corporations may be reasonably expected to work together, and that the argument which asserts that the Federal financier may make use of the statistical service which the Interstate Commerce Commission must maintain may be generalized to express the relations between the financial and administrative branches of government, so far as municipal and State monopolistic industries are concerned. But whether this industrial service be undertaken or not, inasmuch as taxes on corporations are assigned as the chief source of revenue to the States, and a very important source of revenue to the municipalities, it is clear that the essential step to the realization of this idea is the establishment of a statistical service which shall begin its work with the organization of the bookkeeping of the corporations themselves.

There is another way of arriving at this conclusion. The general property tax broke down because the investment of property in large industries under the corporate form enabled men who were so inclined to evade the payment of taxes, and it is a natural development of opinion which asserts that the corporation should be substituted for the individual as the personality to be taxed. The reason for this is that the corporation must have a legal domicile, it must have visible property or agencies, and it must keep a set of books. It was at first thought that the desired result would be attained by substituting the property of the corporation for that of the investors in the corporation, but, for reasons

given in the discussion on the proper basis of corporate taxes, this thought was quickly abandoned. It is the commercial results rather than the visible agencies which furnish the true measure of the ability of corporations to pay taxes; and, should the State fail to provide the means of discovering these results, its experience with the taxation of corporations will be no more satisfactory than was the case with the taxation of personal property. The difference in the two cases is that no amount of organization on the part of the administration could lead to the discovery of personal property, while a comparatively inexpensive organization will lay bare every fact necessary to the just assessment of corporations. Let it, however, be understood that without information no taxing system whatever can work satisfactorily.

(c) *Organization within the Municipalities*—A detailed consideration of the administrative necessities of municipalities, regarded from the point of view of the financier, would result only in a repetition of this cry for information. According to the programme here outlined the city must rely for its income on the taxation of the rental values of real estate, on the taxation of personal incomes, and on some means of approach to the social product of municipal monopolies. The first of these is what is left of the general property tax, and the machinery of assessment and collection familiar to the law is adequate for its successful administration. The second would necessitate organization among the members of the respective professions, but once set on foot would necessitate no especial care on the part of the State. The third, however, assuming for the statement private concessions rather than public ownership, is neither more nor less than a corporation tax, but a corporation tax imposed under conditions which warrant the assertion of the public interest in its most extreme form. This being the case, all that has been said when considering the administrative needs of the Federal and State governments relative to the importance of a competent bureau of statistics and accounts, whether in the interest of public control over corporations or of just taxation, pertains with especial emphasis to the relation existing between municipalities and municipal monopolies. Here, then, as elsewhere, the first

step towards administrative efficiency is to provide for an authoritative system of accounts for all corporations, and to demand reports from corporations on the basis of these accounts

One word only remains on which this treatise may appropriately speak. If public corporate accounting is to be established, it must, in order to be effective, be established on a uniform basis. So far as the municipalities within a given State are concerned this uniformity may be made to rest on State law. Whether or not the administration of the supervisory jurisdiction over corporate management should be with the State or the municipality lies beyond the limits of our present discussion. There is no reason in the nature of the case why every corporation created within a State should not keep its books after a uniform plan. With regard to interstate operations, also, which lie within the jurisdiction of the Federal Government, uniformity of method may be easily attained. The difficulty arises in connection with those interstate relations over which Congress has no control, and in the fact that there exists no recognised legal means of securing uniformity in the treatment of the same class of accounts in the several States. There is but one way of overcoming this difficulty, and that is through interstate agreement. Lest, however, the interest which we may assume has thus far been granted this programme of financial reform should be withdrawn by thus calling attention to what is logically involved in its perfect realization, we hasten to add that it is possible for it to be worked out by means of the independent action of the States and the Federal Government. A Congress of the States for the consideration of those industrial and fiscal questions resulting from the fact that modern trade extends beyond the territorial jurisdiction of local and State governments is highly desirable from every point of view; but it is not essential to the realization of the most important features of the scheme that has been outlined. Indeed it is claimed as a point in favour of the plan here presented that it can be carried to practical success under the exercise of such rights as existing governments now possess. And as giving an added interest to this scheme, it may be remarked that

the revenue system to which we have given approval is the natural evolution of the corporation tax, which in a peculiar sense pertains to industrial conditions as they are found in the United States.

lic credit is a most useful instrument when employed under the direction of a wise and conservative policy, but the slightest disregard of those rules for its use laid down by the laws of its own nature will surely work mischief to the State guilty of so serious an abuse

76. A Government Bond Considered as Commercial Paper.—To say that a State secures an income through the use of its public credit is equivalent to saying that a government borrows money. The transaction itself is a very simple one. Assuming adequate authority to have been granted by law, without which no act of the public administrator is binding, the public treasury offers its bonds for sale in the same way and under very much the same conditions as a private corporation might do. The bond, which is a contract in the form of a simple promise to pay, names all the terms of the loan. It states in explicit language the respective rights of the contracting parties, and the price that will be offered for it, by which the cash proceeds of the loan to the government is determined, will depend in large measure upon the terms named.

Quite a number of facts are implied in this statement that a government bond is a form of commercial paper, and that it is drawn as a contract between a borrower and a lender of capital, for, although the form of public credit is the same as that of private credit, its life or its character is essentially different. In the first place, although the transaction is in the form of a private contract, it cannot be overlooked that one party to the contract is a government invested with sovereignty, while the other is an individual vested with the rights of private property; from which it follows that the security which underlies a public bond, and without which it can possess no value whatever, is different from the security that underlies ordinary commercial paper. Confidence in a private bond is due to the fact that it is a mortgage as well as a note; that is to say, the contract gives the lender the right to enter into the possession of some definitely described property in case the borrower fails to meet his obligation. The holders of railway bonds, for example, can seize the property of the road, or of such portion of it as is mentioned in the bond, if the corporation fails to make payment of interest or of principal according to the terms of the contract. The

lender in this case finds his security in the contingent ownership of a specific piece of productive property.

There can, however, be no such security in the case of public bonds, for the State, although a party to a commercial contract, is at the same time a political sovereignty, and for that reason cannot be approached by any of the ordinary legal processes. This explains why a public bond is not commonly drawn as a mortgage but as a simple promise to pay; and, except when very weak or semi-barbarous states borrow money, the addition of the mortgage clause would not increase the confidence which a lender might feel that his money is safely invested. The State, being sovereign, cannot be sued except under conditions which it itself prescribes, and even then, since there is no one higher in authority than itself, it must be the judge in its own case.

Upon what, then, rests the confidence of the public that money loaned to the government is well invested? The answer to this question is a simple one. A modern State is obliged to maintain its credit in order to retain its influence. The difference between three per cent and six per cent in the ability of a government to borrow money is the difference between strength and weakness. An army may be defeated, warships may be destroyed, but as long as resources are abundant and at the command of the government at reasonable rates, that government may still retain its influence in the councils of the nations. It is the instinct of self-preservation which causes a public minister, jealous for the power and dignity of the government he represents, to be solicitously anxious that all public agreements should be strictly and even generously fulfilled. It is the importance of public credit to the State, taken in connection with the difficulty of its establishment and the ease with which it may be shattered, that is the basis of the confidence of lenders in the promises of a government. The reasoning upon which this conclusion rests is the same as that which leads a banker to regard a bill of exchange as the safest of all ordinary investments. Such bills must be honoured at maturity, or the man against whom they are drawn cannot longer continue in business.

Although the State cannot divest itself of its sovereign character, the financier must, when he appears upon the

money market in search of funds, conform in all particulars to the conduct of private transactions. The motives to which he appeals must be those recognised by the commercial world, and the terms of the contract which he proposes must adjust themselves to the needs of a successful bargain. In no other transaction which the public financier is called upon to contemplate can he forget so completely that he is the representative of a corporation clothed with the right to coerce its clients. It thus appears that the difference between revenue by taxes and revenue by the employment of public credit is a fundamental one. The former rests on coercion, the latter on agreement; the former emphasizes the public interest when contemplating the relations of the State and the individual, the latter the private interest; the former makes its terms holding in view only its own needs and relative justice as between citizens, the latter adjusts its terms to the desires of a particular class of citizens. In determining whether or not a loan should be undertaken the government includes within its argument all those considerations of public policy or sovereign authority that pertain to it as government, but the process of loan-making and of loan management must follow the rules of private financiering.

78. Industrial Effects of Public Borrowing.—The nature of public credit will be further disclosed by observing the industrial results that follow its employment. We shall not consider in this connection an operation in credits which extends no further than to affect the form in which public obligations exist, as, for example, the exchange of bonds bearing a higher for bonds bearing a lower rate of interest. This is doubtless an operation in credits, but it does not bring the government into competition with industries in their demand for capital, and on this account it lies outside the direct influence which public borrowing may exert upon the industrial life of the nation. The true method of analysis is suggested by the statement that capital is potential industry. Its quantity at any given time is limited, and, like all limited quantities, its employment in one manner precludes its employment in another. The industrial effect of public borrowing, therefore, must show itself in the fact that capital which might develop or sustain industries under the direction of private control

is taken over by the State, and if, as we shall assume throughout the greater portion of this discussion, the capital borrowed is put to a non-industrial use, it is evident that the demand made by the State for funds through the placement of its bonds will disturb the orderly development of industry, if indeed it does not check that development or proceed so far as to cause the fall of industries already established

A complete analysis of the industrial effect of public borrowing will distinguish three cases, according as the government fills its loans at normal, at high, or at excessive rates of interest. These cases will be considered in the order named, and, that the situation may be presented in a concrete manner, it will be assumed that the government is obliged to sell its bonds to procure funds with which to prosecute an expensive war

(1) *Loans Placed at Normal Rates of Interest*—A public loan which offers only the normal or usual rate of interest cannot affect established industries. It must be filled, if at all, from the fund of free capital, that is to say, capital which, except for the demand of the State, would be consumed in the pleasure of living or devoted to the extension of the fixed plant of the nation. While the rate offered by the government is no higher than the normal rate in the community no competition is established between investments in industries and investments in public bonds, and we are consequently justified in concluding that a public loan so placed is followed by no unusual or peculiar industrial results

It is sometimes asserted that the offer of the government to pay interest on money loaned induces men to save where otherwise they would not save, and for this reason that a public loan results in a positive advantage independently of the use that may be made of its proceeds. There may perhaps be some truth in this suggestion for those nations that have not as yet developed a healthful system of private credits, but as a rule it may be asserted that saving cannot be greatly stimulated by the offer of public bonds at normal rates of interest.

It has also been claimed that the placement of a public loan must affect industries because it will be followed by a rise in the price of capital, which is equivalent to saying that a government cannot fill a loan at a normal rate of in-

terest This may be true, provided the demand of the government is in addition to the ordinary demand for industrial extension, and this will, of course, depend upon the purpose for which money is borrowed and the conditions under which the government appeals to the money market If the purpose be industrial there will doubtless arise a certain degree of competition between the government as an undertaker and individuals as industrial promoters Should the competition prove to be active a wise financier will defer his project, for the time in which the government should become an investor of capital is when, through depression of business expectations, there is a surfeit of free capital upon the market *

If, on the other hand, the purpose for which the loan is placed be to provide funds for a war there can be no "extra demand" for capital. The government may spend more, but individuals will spend less. Moreover, the uncertainty which attends a condition of war will tend to check private investment, and provided the government has adopted a sound fiscal policy for the conduct of the war, and provided the purpose of the war meet the approval of the public, it can at least secure what money it needs at normal rates of interest. Our general conclusion, then, needs no modification. A loan that proceeds no farther than to draw into the public treasury the free capital which at any time exists will not seriously affect industrial conditions.

(2) *Loans Placed at High Rates of Interest*—Let it now be assumed that the government needs more money than it can secure by offering the usual rate of interest, and that in consequence it raises the rate which it offers above the normal rate. Provided its credit is not impaired the government will doubtless procure the money which it needs. What will be the industrial results that follow this second step in loan financiering ? It is clear that these results will depend upon the character and importance of the funds that are thus approached by the government, and it is therefore incumbent upon us to inquire respecting those funds.

There are three funds of capital that may be placed at the disposal of the government on account of its offer of a

* The financial success of State railways in Prussia is largely explained by the fact that they were purchased at a time of serious commercial depression.

rate of interest higher than the usual or accustomed profits accruing to industrial investments. In the first place, something may be expected from a saving in personal expenditures, and here for the first time is it possible to trace a direct relation between public borrowing and industrial affairs. If commodities commonly consumed cease to be used in order that the money thus saved may be expended in the purchase of public bonds the producers of such commodities will cease to find their full employment, and the temporary embarrassment thus occasioned will, by a process familiar to the student of economics, react upon all industries. This at least would be the result were there no counteracting influences. It is not likely that a government would take this second step in the placement of a loan were it not in need of men as well as of money, and the embarrassment to which we have referred would in large measure be relieved by this fact. In the case of a war, for example, the men thrown out of employment as a result of the saving occasioned by the high rate of interest offered by the government would find employment in the army, upon which the capital thus collected would be expended.

The second fund of capital placed at the disposal of the government because of the high rate of interest offered results from the abandonment of industries which were upon the stage of paying no profit before the government made its appearance as a borrower, and from the suspension of industries which a change in demand has rendered temporarily unprofitable. Fixed capital cannot, of course, be transferred to the government, it is the circulating capital as represented by the proceeds of the last sales, or the accumulated surplus of past years, that must go to the purchase of public bonds. This is a fact of considerable importance in tracing the industrial results of the placement of a loan at a high rate of interest, for it shows that the influence of such a policy is limited by one of the simplest of commercial laws. Public bonds will not be purchased with funds necessary to maintain an established industry in a profitable state of activity except the rate that can in this manner be secured on the free capital gives rise to a larger annuity than the profit which accrues from the use of the fixed capital. Were it not for this natural limitation of investments it might be dan-

gerous for a government to offer a rate any higher than the established rate of profit in the community, for it would by so doing induce the abandonment of useful industries, as the matter stands, however, this second step in loan financing may be of positive advantage to the community, inasmuch as the opportunity to purchase public bonds may serve as a temporary refuge for investors who are seeking to change their line of investments. If the political policy of the government be the occasion of the embarrassment which necessitates a readjustment in investments there is in this fact an added reason for placing bonds at a high rate of interest

The third source from which government loans may be filled in response to an offer of high interest results from the increased activity of those interests which continue to enjoy their accustomed demand. The managers of such industries recognise that government bonds offer an easy investment at good rates for practically unlimited amounts. The possibility of an outlet for capital accumulated gives an added motive for its accumulation, and the only means of securing this is through the application of greater energy or skill to the industries maintained. No one can say that the spirit of technical invention or the ability of business organization has exhausted itself. On the contrary, there is every reason to believe that motive alone is necessary to bring yet greater talent to the service of the business world. If this be true, and if the offer of a high rate of interest can serve as a stimulus to energy and application, not only will the result be of immediate advantage, but it will entail remote benefits as well. While, then, it may be said that only an exigency can warrant the disturbance of established business relations through the offer of a high rate of interest on public bonds, it is equally true, provided the exigency in question, as, for example, a war, has disturbed those relations, that the commercial adjustment which must follow will be assisted rather than hindered by what we have termed the "second step in loan financing"

(3) *Loans Placed at Abnormally High Rates*—The third step in loan financing is taken when the government seeks to fill its loan by the offer of an abnormally high rate of interest, and it is a step commonly followed by most unfortunate results. The permanent interests of the treasury and the social interest of the community are alike opposed to the po-

licy of borrowing money under conditions which necessitate the payment of abnormally high rates. A moment's consideration will show why this is the case.

So far as the interest of the treasury is concerned the appearance of the government on the money market as a strong competitor for capital will tend to dry up the sources from which money may be secured through taxes. There is always at any given time a class of industries that stand upon the margin of profitable returns, but should the established rate of profit be raised by the offer of a high rate on government loans many of these weaker industries would endeavour to release their capital from industrial investment to place it at the disposal of the nation—a procedure which curtails the fund from which taxes are paid, while at the same time it increases the annual charge imposed upon the proceeds of taxes. Nothing could be more pernicious, and only imperative necessity could warrant the offer of excessive rates even as a temporary expedient.

The social interest opposed to this policy is equally clear. Nothing can be more unfortunate for a community than an arbitrary and therefore a temporary change in the general scale of prices. Calculations become difficult and all business takes upon itself a more or less speculative character. The best illustration of such a change is the sudden rise of prices due to monetary inflation. But a similar result would follow a rise of prices due to the non-commercial rise in the accepted scale of profits such as would follow the offer by a government of abnormally high rates upon its loans. The government would doubtless get the money, partly, as we have said, from the release of capital from industries which have become relatively unprofitable, and partly by the unusual profits of those who sell goods produced at the old cost at an advanced price. In the competition that follows an arbitrary rise in the scale of prices the gain will always lie with those who possess goods that respond quickly to industrial changes, while the loss will be sustained by those who seek to sell goods that are commercially sluggish. There are many applications of this generalization, all of which show that the industrial readjustment which follows the placement of a public loan at unusually high rates of interest must work unfairly as between citizens. A single illustration will suffice.

The goods which the labourer consumes respond almost immediately to any change in commercial conditions, while the commodity which he sells is of all commodities the most sluggish in its movements. This being the case, it is evident that during the period in which wages are rising as the result of the increased cost of living the employer is in receipt of an unusual profit. The funds thus concentrated in his hands may perhaps go to the purchase of public bonds, but it is certainly a result that no government can contemplate with satisfaction, that the burden of its loan is borne by one class of its citizens while the advantage is enjoyed by another. The placing of a loan under the conditions assumed tends to the unequal distribution of wealth, it intensifies class relations, and from every point of view must be regarded with disfavour. A wise government will foresee these pernicious results of an extensive application of the loan policy, and provide in time against the necessity of appealing for funds by the offer of excessive rates of interest.

Our general conclusion, then, is as follows: Loans at normal rates of interest are followed by no very important industrial results; loans at a rate slightly in advance of the normal rate will disturb somewhat the placement of capital, but, provided the occasion of the loan is such as to cause a readjustment of commercial relations, the action of the government may be regarded as positively advantageous; but to carry the rise in the rate of interest so far as to become itself a cause for commercial disturbance would be followed by results for which no conservative government would care to be responsible. No part of financial administration calls for a keener business sense than the placement of government loans.

79. When may Public Credit be Employed?—This question, which is naturally introduced by the foregoing analysis, will lead to a yet clearer appreciation of the nature of public credit. As already remarked, credit gives rise to anticipatory revenue. The placement of a loan must sooner or later be followed by the levy of a tax. We need not argue this point, for no writer or statesman since the seventeenth and eighteenth centuries has claimed that a public debt is a public blessing. Nor is a public debt a public evil. Public credit, considered by itself, has no moral or social quality whatever. It is one of several means of procuring public

funds. Unless the government is in need of money neither a loan nor a tax can be justified, but, assuming that one or the other of these means of securing money must be employed, a great deal depends upon the choice of means made by the financier.

Coming at once to the answer of the question asked, for we are not at liberty to enter upon an extended analysis, it may be said that there are three objects for which a government may properly borrow money. These are as follows:

To cover a casual deficit.

To provide funds for an emergency.

To provide funds for industrial investment.

(1) *Loans may be Used to Cover Casual Deficits*—In a previous chapter the question of a deficit in specific appropriations was brought to the attention of the student, and it was concluded that an efficient fiscal system will provide some means by which an inadequate appropriation may be made good in order that the projects approved by the legislature need not be embarrassed in their execution. The question that now claims consideration pertains to deficiency in general income rather than to deficiency in a specific appropriation. In discussing this question it will be assumed that there is ample revenue legislation, but that for some reason the income of a particular year has fallen short of the accustomed income. It may also be assumed that the loan under consideration is an act of the legislature and not of the government, since in this manner we avoid the intrusion of any parliamentary or constitutional questions that might be raised. Under such circumstances the claim here urged is that a sound system of finance will make orderly provision for covering a possible casual deficit by a temporary loan.

The reasons which favour such a conclusion are three: In the first place, there being an orderly and well-recognised provision against a deficit, its appearance cannot operate to the injury of public credit or public administration. The "psychology of the crowd" is not very well understood, but one of its minor laws is that in matters pertaining to public policy the opinion of the public is less sensitive to an event, no matter how threatening it may be, than to an apparent lack of preparation on the part of the government to make headway against it. It is not enough that a people have resources; the govern-

ment must have the means of availing itself of those resources without hesitation and without exciting comment.

In the second place, the only provision against a casual deficit is found in such an underestimation of income or overestimation of expenditures as to guarantee a constant surplus. It is therefore necessary to inquire which is preferable in public financing—close estimates with possible deficits and temporary loans to cover them, or loose estimates with broad margins for contingencies and a probable surplus. The question being presented in this manner, we answer without hesitation that a wise fiscal policy will approve deficit rather than surplus financing. This is true because a constant excess of income over approved expenditures will exercise a bad moral influence on the legislature and induce it to approve expenditures without scrutiny which under other conditions would be disallowed. It is a wise rule that no new expenditure should be voted until after the legislature has considered the ways and means by which it is to be met. Legislation in the presence of an overflowing treasury is sure to be foolish legislation. This point, like the former one, seems so clear as to require neither illustration nor comment.

The third reason in support of a policy of temporary loans can only be approached indirectly. It will be noticed that the loans here contended for are temporary loans, and it is evident that this must be the case, since otherwise a policy of deficit financing would lead to a constantly increasing public debt. There is no warrant in the above argument for permitting the average income for a series of years to stand below the average of expenditures for the same period. It may be that the casual deficit which was the occasion of the loan is due to a reduction of imports, in which case it may confidently be expected that revenue will recover when business revives, and it is no slight advantage of the loan policy that the deficit of a poor year may be thus thrown over onto the surplus of a good year. The necessity of a change in the revenue laws, than which there can be nothing more pernicious, may be thus avoided. The great service of a policy of temporary loans, therefore, is found in the fact that it relieves a legislature from the necessity of too frequent changes in the rates of taxation.

One word further may be added respecting this policy. Like all forms of credit financing, it will succeed or fail

according to the provision made for it in the orderly revenue system. The need of an elastic revenue has already been presented; it may now be observed that the easy administration of a policy of temporary loans demands a mobile revenue as well. Were it possible that the surplus and the deficit of a series of years could balance the issue of loans to cover deficits need be the occasion of no thought on the part of the financier; but such a balance cannot be expected, and on this account the financier must attain this balance through the adjustment of income. To do this in such a manner as not to disturb the general revenue system it would seem wise that a few specific taxes be placed at the disposal of the financier, the rate upon which might be raised or lowered annually according to the demands of temporary loans. Suppose, for example, that a tax on the import of tea be assigned to this service, or such portion of it as may be necessary, to move the income of the government up or down according to the exigencies of the temporary debt, the revenue system as a whole would be unaffected by a surplus or a deficit, the government would have no excuse for an increase in its permanent debt, and no industry within the country would in any way be affected by the modification of the tax.

We therefore conclude for the three reasons named that temporary loans are a legitimate part of an orderly fiscal system, but in the establishment of this policy the legislature must make ample provision for its successful administration by assigning to its service a mobile revenue.

(2) *Loans may be Used to Meet a Fiscal Emergency*—By an emergency is meant any calamity, or threatened calamity, which gives rise to an immediate demand for public funds. A war or threatened invasion may be regarded as such an emergency. Under such circumstances a government is justified in borrowing money and for two reasons:

First, the demand for money being due to an emergency, the government cannot wait to secure it by the levy of new taxes. Experience shows that considerable time is required to bring a new tax into working order. In 1812, for example, a direct tax was levied to provide for the war that Congress had seen fit to enter upon, but the tax did not become productive until two years after it was levied, and the largest amount of revenue accruing from it came to the government in 1816,

after the emergency had passed away. Nor can an emergency demand be met by raising the rate of existing taxes; for, in the first place, it is not sure that such a measure would, under the commercial conditions of a threatened war, result in an increase of the revenue, and, in the second place, arbitrary and unadvertised changes in a revenue system do not lie within the contemplation of reputable states

Second, the only other means of providing against an emergency so as to avoid the necessity of borrowing lies in the accumulation of a surplus which can be used when the emergency arises. This is regarded as sound financiering when followed by private corporations, although it must be said that even in this case the larger the enterprises considered the more difficult will it be to make use of an accumulated surplus. If this surplus be invested in profit-bearing obligations it is apt to fail of its purpose when most needed, because such obligations could not be easily sold on a stringent market; an uninvested surplus, on the other hand, would be a very expensive sort of commercial insurance. As applied to the government, however, the policy of storing up money or values as against a future contingency is without reason. If it consist of specie, not only will its accumulation act as a contraction of that portion of the circulation which is the basis of all credit relations, but its expenditure, which from the nature of the case must be almost instantaneous, will act upon the circulating medium like the discovery of an unusually productive mine. Nothing could be worse than this slow contraction of the world's specie to be followed by sudden inflation. To say nothing of the commercial disasters that would follow such a policy, a government itself would be greatly embarrassed by the influence which such a policy would exert upon the price of those things which it might be called upon to purchase

If, on the other hand, this reserve be made up of interest-bearing obligations the policy presents itself in no more favourable light. The difficulty comes when the government seeks to make use of its fund of invested capital. No government would care to use such obligations as collateral security, for it would be simpler and equally cheap to borrow the money outright; nor could the government sell its securities to advantage, since, the occasion

of the sale being a public emergency and the amount thrown upon the market large, their price would inevitably fall. Only in the case of barbarous states operating in the midst of civilized states of higher credit can any reason be urged for the accumulation of a war fund, and then only when such states possess sufficient sagacity to purchase the highest priced bonds that the world offers. It is theoretically possible for a government without credit dealing in the values of a government of unblemished credit to realize more by the sale of foreign obligations than by the issue of its own obligations, but a people possessing such sagacity would be likely to enjoy a high credit of its own, in which case the argument would not apply.

The unreasonableness of this policy is further seen when it is noticed that the transaction contemplated is merely a transaction in credits. The sale of an accumulated investment is equivalent to the placement of a debt, and the accumulation of an investment preparatory to sale is equivalent to the payment of a debt. It cannot be argued that by means of previous accumulation a government is enabled to secure more money than would otherwise be the case, or to increase its receipts more quickly or more easily than by the simpler process of borrowing money, for the fund of free capital is at any time a limited quantity, and any portion of it absorbed by the sale of existing obligations cannot be absorbed by the sale of newly created obligations. Why, then, should a government impose taxes in time of peace in order to accumulate a fund against an emergency if, when the emergency comes, the fund renders no service that cannot be as well, if not better, rendered by the sale of new obligations? The most efficient provision against a fiscal emergency consists in a flourishing condition of industry, and a government which deserves the confidence of its subjects will be able to obtain immediately and for the asking all the money it may need. The danger which lies in credit financiering is, not that a government cannot by means of it obtain funds to make headway against an emergency, but rather that the ease with which funds can be obtained will induce a government to declare an emergency where none exists. Our conclusion, then, is that a fiscal emergency as well as a temporary fiscal embarrassment warrants the employment of public credit.

(3) *Loans may be Used to Procure Funds for Public Investment.*—The third occasion for the employment of public credit arises when an extensive scheme of public investment has been voted by the legislature, a statement for the support of which two reasons may be presented

In the first place, this is the only economical method of going to work. Were it possible to proceed slowly with the work the necessity of collecting a sufficient amount of capital at the beginning to carry the enterprise to completion might not be imperative, but it is not possible to proceed slowly with such enterprises as are now under consideration, as, for example, railways, levees, dredging of rivers, and the like, for not only are such enterprises unable to bear an interrupted construction without damage to the work already done, but the part that is finished represents an idle investment until by completion the whole may be put in operation. Improvements of this character should be carried through from start to finish rapidly and without interruption. It is thus evident that small annual appropriations are condemned by both the engineer and the financier.

Such being the case, the only means of obviating a debt would be to levy a tax adequate to the demands of the engineer, but such a policy would disregard that principle of finance which asserts that a sound taxing system must be stable. Changes in rates, and the shifting of commercial conditions which such changes entail, are frequently a more serious burden to industry than the payment of a tax. This burden may be obviated by the placement of public bonds, for the payment of the bonds (so far as it comes from taxes), being spread over a series of years, will be the occasion of no disturbance or serious change in the form or rate of taxation. There is, then, economy in the loan policy, whether regarded from the point of view of the enterprise undertaken or of the relation which the enterprise holds to taxes.

The second reason for the employment of credit in collecting capital for public industries is limited in its application to investments that are industrial in character. An industrial investment, as the phrase is here used, is peculiar in that the service which it renders may be particularized and a payment for it demanded from the individuals who enjoy the service. A railway owned and operated by the State is an illustration

of such an investment. In the case of such an enterprise it is generally conceded that the capital required should be supported by the charges for service rendered, a result which could not easily and naturally be accomplished were the government to procure the funds without the creation of a special class of obligations. It thus appears that the policy according to which the contemplated work shall be administered is involved in the means in which it is set on foot; and to render more easy a commercial management it seems wise to adopt commercial methods at the outset. This means that the funds for an industrial investment should be collected by the sale of bonds resting in the first instance on the enterprise in question, but rendered salable at a high price by the fact that the general revenues of the State are mortgaged for their payment.

The three occasions which have been presented are believed to be the only ones which justify the use of public credit. They are the rise of a casual deficit, the appearance of a serious emergency, and the voting of extensive public works. The nature of public credit is clearly exposed by the use which may be justly made of it. The great service which it renders is to give steadiness to the fiscal system, which, after all, is the chief mark of successful financiering. Public credit as a source of revenue cannot be regarded as a casual expedient. It is an integral part of a well-ordered fiscal system the recognition of which would save many peoples from the abuses now practised in the employment of their credit.

CHAPTER II.

EMPLOYMENT OF PUBLIC CREDIT.

EMERGENCY FINANCIERING. INVESTMENT LOANS.

It is the purpose of the present chapter to consider some of those fundamental questions that arise in the employment of public credit. So far as temporary loans are concerned nothing need be added to what has been already suggested in the foregoing chapter. Provided efficient rules have been framed for estimating income and expenditure, and provided the revenue system possess adequate mobility, the financier can answer all questions that arise in connection with a policy of temporary loan financiering by the application of simple business principles. But this is not true of emergency or of investment financiering, and for that reason the employment of public credit to meet an emergency or to provide funds for investment calls for special consideration.

79. Emergency Financiering —There are many sorts of emergencies to which the finances of a nation are exposed, a complete presentation of which would require their definition and classification, to be followed by a consideration of the peculiar fiscal necessities of each. This, however, we shall not undertake, but, selecting the most serious of all emergencies that can occur in the life of a nation, we shall content ourselves with a discussion of the appropriate management of a public treasury in time of war. In a sense the entire subject will be presented by this method of procedure, for the rules and principles arrived at in studying the necessities of war financiering may be applied, though in a modified form, to all classes of fiscal emergencies.

It will be of some advantage to grasp at the outset the magnitude of the operations that may be forced upon the public treasury by the advent of an expensive war. In the War of the Rebellion, for example, it was necessary for the government within the space of four years to increase its revenue from 65.2 millions of dollars to 960.6 millions of dollars. To express the problem in another way, the expenditure of the government in 1861 was about two per cent of the gross product of the nation, in 1865 it was in excess of twenty-six per cent of the gross product. This is indeed an emergency, and to administer a public treasury under such circumstances so as not to involve the nation in ruin demands a clear policy firmly followed from the beginning to the end of the period of financial distress. Reasons have already been submitted why reliance cannot be placed upon taxes as the exclusive means of procuring funds in time of fiscal emergency, and were one inclined to question the adequacy of these reasons it would seem that a statement of the magnitude of possible demands ought to be final against the policy which aims to support a war by taxes alone. Should a financier have the temerity to undertake it? Use must be made of credit, but the financier ought to use it in such a manner as not to destroy it. Under no conditions is the maxim laid down in the Introductory Chapter of this treatise more important than in connection with war financiering. That maxim, it will be remembered, is that a sound fiscal system will not tend to dry up the source of revenue upon which it relies.

If new taxes cannot be used as the basis of war financiering to the exclusion of credit it is equally true that credit cannot be so used to the exclusion of new taxes. Both reason and experience may be brought to the support of this assertion. Credit cannot sustain itself. It must be based on revenue, and as the ordinary expenditures of the nation are not materially decreased on account of a war, the income from taxes must at least be increased to cover the interest which accrues on the loans contracted. To do less than this would be to base credit on credit, a procedure which would inevitably lead to financial disaster. It does not, then, seem necessary to consider at length this phase of credit financiering. It is not approved by business practice, and has never,

so far as the writer is aware, been formally put forth as a theory for the financial management of a war.

Admitting, then, that interest payments at least must be drawn from new taxes and not taken from the proceeds of new loans, we come next to inquire if all war expenditures, exclusive of interest payments, should be made through loans ? In this form the question is worth serious discussion, for the policy thus brought to notice has been a favourite one with financiers. There is, of course, no reason, so far as the mathematical theory of a fiscal policy is concerned, why such a programme might not succeed ; but when it is observed that a great war modifies the established demand, changes the current of industry, and diverts the course of employment, in short, substitutes a condition of war for a condition of peace, it must be acknowledged that other elements besides those embraced within a mathematical expression ought to be recognised. In ordinary times when there is no question respecting the stability of the State and no fear of radical measures of any sort it may be adequate for the support of a credit policy that provision is made for interest charges ; but in times of excitement and rapid change, no matter what the occasion may be, it is essential for the support of credit that the government show manifest strength. It must resort to taxes with sufficient vigour to prove that in a degree at least it is independent of the money-lender. A financial policy which proposes to rely on credit to the exclusion of taxes shows weakness at the outset and will tend to depress the credit it is designed to use ; a financial policy, on the other hand, which proposes to rely on taxes, but to supplement them so far as they may be inadequate by the issue of loans, is an evidence of fiscal vigour and will tend to strengthen credit even before the newly levied taxes have become productive.

It is not necessary to enter upon an extended analysis for the support of such a conclusion, for there are many illustrations in the history of war financiering of the inadequacy of loans when not based on the expectation of clear revenue. The policy of carrying on a war by means of credit was adopted in the United States in 1812 and again in 1861, and in both cases proved to be weak and inefficient. In support of this statement the financial management of the war of 1861 may be

very briefly presented.* The report in which Secretary Chase presented his plan to Congress was rendered in July, 1861. After calling attention to the large sums required by "the existing emergency," and asserting that deficiencies in the revenue must be supplied from loans, he states that "the problem to be solved is that of apportioning loans and taxes in a proper manner." This is certainly a correct statement of the problem. The view entertained by the Secretary as to the proper apportionment of loans to taxes is suggested by the following quotation from his report:

"It will hardly be disputed that in every sound system of finance adequate provision by taxation for the prompt discharge of all ordinary demands, for the punctual payment of the interest on loans, and for the creation of a gradually increasing fund for the redemption of the principal is indispensable. Public credit can only be supported by public faith, and public faith can only be maintained by an economical, energetic, and prudent administration of public affairs, and by the prompt and punctual fulfilment of every public obligation."

This financial policy may be more clearly apprehended if we notice the estimates presented by the Secretary. He proposed to raise \$80,000,000 by taxes as against \$240,000,000 by loans. Of this amount of clear revenue \$65,800,000 were required to meet the ordinary expenditures of the peace establishment. It was believed that existing laws would provide about \$60,000,000, from which it followed that new taxes to the amount of \$20,000,000 were required. Of this sum \$9,000,000 were to be devoted to payment of interest upon the new debt, and \$5,000,000 to the establishment of a sinking-fund for its final expungement. Such was the financial plan upon which this great war was begun.

In the December report, 1861, the Secretary declared renewed confidence in the financial plan which he had previously presented. It was found, however, that receipts from customs and from the sale of public lands had fallen off, and there seemed, therefore, just ground for apprehension lest existing

* I shall avail myself of the account of the financial management of this war to be found in my "Public Debts," pp 126 to 133 inclusive. In the same treatise will be found an account of the financial management during the War of 1812, pp 111 to 125 inclusive.

taxes should fail to support the peace establishment and the loans which the government chose to place. This fear of a deficit from ordinary sources of revenue impressed itself upon the mind of the Secretary, and, in consequence, he proposed additional duties on tea, coffee, and sugar, a modification of the income tax so as to render it more productive, and a tax on whiskeys, tobaccos, banknotes, instruments of conveyance, and the like; in short, he proposed the establishment of a system of internal duties. Now all this has the appearance of an abandonment of the loan policy, and the adoption of the policy of carrying through the war by taxes, but this is true in appearance only. The total sum of clear revenue hoped for from all these sources of income was but \$90,000,000, and this, as the Secretary said, was not more than enough to meet "even economized disbursements, and pay the interest on the public debt, and provide a sinking-fund for the gradual reduction of its principal." "It will be seen at a glance," says the report in another place, "that the amount to be derived from taxes forms but a small portion of the sums required for the expenses of the war. For the rest reliance must be placed on loans."

It was in the latter part of the year 1863 and during the first part of 1864 that the inadequacy of the loan policy as a basis of war financing forced itself upon the minds of those who managed public affairs. "To check the increase of debt," says the Secretary, "must be, in our circumstances, a prominent object of patriotic solicitude." And again: "Hitherto the expenses of the war have been defrayed by loans to an extent which nothing but the expectation of its speedy termination could fully warrant." The report then restated the financial policy as adopted in 1861 and continued: "The financial administration of the first fiscal year after the outbreak of the Rebellion was conducted upon these ideas. The Acts of Congress at the extra session of July, 1861, were framed with the intention of supplying the full amount of revenue demanded by them. But receipts disappointed expectation, and it soon became obvious that a much larger proportion of the means needed for the fiscal year 1862 than the principle adopted would allow must be derived from loans."

But the most interesting expression in this document per-

tains to the estimates for probable future demands: "These statements," says the Secretary, referring to the estimates, "illustrate the great importance of providing beyond all contingency for ordinary expenditures and interest on debt, and for the largest possible amount of extraordinary expenditures, by taxation. In proportion to the amount raised above the necessary sums for ordinary demands will be the diminution of debt, the diminution of interest, and the improvement of credit. It is hardly too much—perhaps hardly enough—to say that every dollar raised for extraordinary expenditures or reduction of debt is worth two in the increased value of national securities and increased facilities for the negotiation of indispensable loans."

Could this truth have been recognised at the beginning of the war, and could it at that time have influenced the treasury policy, subsequent financial history would have been materially modified.

It is somewhat difficult to exhibit accurately the rapid fall of public credit from 1861 to 1866, but I have undertaken in the following statement to approximate such an exhibit by showing the specie price of all the obligations issued during the war. The computation has been made by estimating the value of the total receipts from credit for each quarter at the average price of gold during that quarter. The only source of error in this method arises from the fact that the average price of gold for any three months may not be the actual price at which the proceeds of bonds were covered into the treasury, but any closer computation requires more complete data than the authorities at Washington have yet given. It is, however, believed that the conclusions may be relied upon as substantially correct.

It seems superfluous to comment on such figures as these. A treasury administration that permits the credit of a wealthy people to decline so that its obligations fall fifty per cent and remain there for a year can hardly be called successful. Yet the results here displayed, as also the forced circulation of treasury notes, follow naturally from the attempt to carry through a war by loans.

What, then, it may be asked, is the correct plan for the administration of a public treasury during the continuance of a war? To answer this question in detail would require

the repetition of many principles that have already received consideration, but it may be asserted as a general statement that a sound policy of war financing is only possible on the basis of a sound revenue system throughout, and it is espe-

TABLE SHOWING TREASURY RECEIPTS FROM PUBLIC OBLIGATIONS OF ALL SORTS FOR EACH QUARTER DURING THE WAR AND THE GOLD VALUE OF SUCH RECEIPTS ESTIMATED ON THE AVERAGE PRICE OF GOLD FOR EACH QUARTER.

| Summary. | Gross Receipts from Debt Created. | Gold Value of Gross Receipts | Percentage Realized |
|--|--------------------------------------|---------------------------------|------------------------|
| For the quarters ending | | | |
| March 31, 1862..... | \$6,094,720,267 | \$5,952,713,284 | 97.67 |
| June 30, "..... | 20,904,920,381 | 20,023,076,350 | 95.78 |
| Sept. 30, "..... | 6,893,442,036 | 5,964,895,394 | 86.54 |
| Dec. 31, "..... | 13,163,147,940 | 10,125,093,395 | 76.92 |
| March 31, 1863..... | 17,856,975,925 | 11,519,535,169 | 64.51 |
| June 30, "..... | 21,646,006,749 | 14,582,914,717 | 67.37 |
| Sept. 30, "..... | 11,826,749,175 | 8,080,050,648 | 75.93 |
| Dec. 31, "..... | 15,045,084,385 | 10,086,224,572 | 67.40 |
| March 31, 1864..... | 19,192,210,442 | 12,022,000,620 | 62.64 |
| June 30, "..... | 23,537,179,192 | 12,258,162,923 | 52.08 |
| Sept. 30, "..... | 14,773,582,242 | 6,129,559,272 | 41.49 |
| Dec. 31, "..... | 17,990,867,429 | 8,030,520,480 | 44.67 |
| March 31, 1865..... | 17,531,337,672 | 8,809,497,180 | 50.25 |
| June 30, "..... | 36,199,562,574 | 25,340,621,914 | 70.02 |
| Sept. 30, "..... | 13,876,572,722 | 9,793,887,364 | 69.93 |
| For the years ending | | | |
| Dec. 31, 1862..... | 47,056,230,624 | 42,065,778,432 | 89.39 |
| " 31, 1863..... | 66,374,816,234 | 45,168,725,136 | 68.05 |
| " 31, 1864..... | 75,493,839,305 | 38,446,243,295 | 50.93 |
| Sept 30, 1865..... | 67,598,472,968 | 43,854,016,398 | 64.87 |
| For the forty-five months of the war..... | 256,523,359,131 | 169,534,763,261 | 66.09 |

cially important that the taxing system should be so organized as to be capable of rapid and easy expansion in case of an emergency. It may not be necessary to increase the revenue from taxes in any great degree, but some movement in this direction must be manifest in order to impress upon the money-lender the fact that the revenue machinery of the government is under perfect control. Provided the importance of preparation in time of peace for the advent of war is duly appreciated, the task of making such provision is by no means difficult. It is only necessary that the basis of the established

system be so broad, and the rates at which it operates so low, that increased revenue will result from increased rates, and that, provided the exigency continues, new taxes *of the old sort* may be brought into operation. Applying this to the situation in the United States, it may be said that elasticity of revenue cannot be expected from customs duties, but that excise duties may be made elastic, provided they are not levied at the maximum revenue rates during years of peace. Moreover, an internal-revenue system, even though it be narrow during years of peace, as is the case with the internal-revenue system at the present time, can be so easily expanded through the machinery already in existence that a law authorizing such expansion would act upon credit as though the new revenue were already in hand. The Federal Government is not in a very bad condition as matters now stand, and if to the sources of revenue which it already enjoys there is added the taxation of internal commerce, and if the rates imposed are adjusted throughout with due regard to elasticity and control, no excuse could be found for a financier who should fail to carry the country successfully through the exigencies of an expensive war.

It is not possible to state definitely the proportion of loans to taxes acceptable to a sound system of war financiering, for the elements that enter into the situation will be different, or at least present themselves in different ratios, in every special case. We may, however, venture one step in the direction of formulating a rule for the financial management of a war. At the beginning of hostilities revenue from loans may properly outbalance revenue from taxes, a ratio, however, which must be gradually reversed until the chief burden of a long-continued conflict shall rest upon the proceeds of taxes. This will find support in the fact that the necessity for loans is greater at the outset than when the newly levied taxes have been brought into a productive state of activity.

But a more convincing reason in favour of the rule is suggested by the industrial effect of a long-continued war. The greatest strain to which the industries of a country are subjected by the advent of a war arises from the necessary adjustment of labour to new lines of demand. This does not seem to be duly appreciated by writers on finance. They do not perceive that the chief strain upon a treasury policy comes

at the beginning of a war. A condition of war is not a condition of peace from any point of view, and the industrial transition from the one to the other is always attended with danger and may prove the occasion of disaster. But if the financier can bridge over this chasm and establish business firmly on a basis of war conditions he can extend his taxing system with as much confidence as if the people were living in a state of peace. It is during this period of industrial readjustment that public credit renders its most significant service to the administration. At no future time during the continuance of a war can such strong reasons be urged in favour of its employment.

It seems, then, that an adequate policy for the management of war finances is a tax policy assisted by credits rather than a credit policy assisted by taxes. It contemplates an increase in the revenue from taxation which shall be gradual and constant until the war demand is met from the proceeds of established taxes. The service of loans is to enable the financier to bridge over the time between the outbreak of hostilities and the productivity of newly levied taxes.

80. Investment Loans.—The character of a loan, as also the rules pertinent to its management, depends in large measure upon the purpose for which the loan is contracted and upon the kind of revenue of which it is an anticipation. This being the case, it is evident that the principles which underlie the act of borrowing to cover a temporary deficit or to make headway against an emergency demand will not apply, at least without modification, when the government borrows for the purpose of making an industrial investment. The conditions are different; the purpose is different; the marks of successful administration are different. A complete analysis of this important subject would carry us beyond the proper limits of an elementary treatise, but we may venture a few considerations by which such an analysis should be directed.

In the first place, it is necessary to distinguish between an investment designed for an unpaid or an underpaid service and an investment designed for commercial administration. The purchase of grounds for a public park, the construction of canals or the dredging of streams, the material equipment for public schools, and other like services, may be accepted

as illustrations of non-commercial or general public investments; the building and equipment of a railway, the creation of a system of forestry, the opening of public mines, or the construction of any of the so-called municipal industries for which there is a specific payment for a specific service, are illustrations of commercial investments. This distinction is a fundamental one in determining the character of investment loans, for it shows that non-commercial loans are in anticipation of revenue from taxes, while commercial loans are in anticipation of revenue that accrues from the rendering of a service. The former are a special class under a general category, the latter form a class by themselves.

The defence of a non-commercial investment loan is found in the engineering necessity of carrying a work once undertaken to its completion rapidly and without interruption. Although the work itself rests on taxes, it should be provided for by a permanent appropriation adequate to the payment of the entire cost within a definite period. The length of time during which this payment should continue, that is to say, the duration of the debt, will of course depend upon the character of the work. If it be of a transitory sort, or subject to the deterioration of use or of fashion, the payments must be large and the duration of the payments short; indeed, a work that is to last for a few years only should very rarely be undertaken except with cash in hand, for nothing indicates more surely an abuse of investment loans than the continuance of a debt after the decay of that for which the debt was created. If, on the other hand, the work contemplated be one that is likely to remain in use for a long time it is legitimate that the annual payments should be relatively small and the duration of the debt more extended. It will be safe, however, to lay it down as a rule that an investment loan should never take upon itself the form of a "perpetual debt." It is not necessary to follow further the characterization of non-commercial investment loans. All that is important for our present purpose is to recognise that they form a special class of obligations.

It is a little more difficult to state clearly the character of public credit when employed to secure funds for a commercial investment. This is in part due to the many forms in which public investments of this sort present themselves;

it is in part due to the fact that such an employment of public credit involves all those considerations which separate a special from a general governmental service; but it is more fully explained when one observes that the fundamental distinctions between a public and a private industry work their way back to the process of borrowing, which is the first step toward the establishment of any important public work. These considerations and distinctions have already received attention, and the student is at liberty to remind himself of them and to apply them as general principles to the question in hand. What we are about to suggest is particular rather than general in character.

From the point of view of the borrower it is not necessary to distinguish between a commercial and a non-commercial loan. The credit upon which he relies is the same in either case. He does not feel called upon to investigate the probable success of the enterprise to be undertaken, since for him it is sufficient to know that the State is jealous of its credit, and that the resources of the government are ample to meet all obligations. It is not surprising, therefore, that the lender does not insist upon a classification of public obligations according to the purpose for which they are incurred.

From the point of view of the government, however, it is believed that such a classification is important. A non-commercial loan differs from a commercial loan in that the former rests on taxes, while the latter rests on earnings. The one appeals to the conditions of general prosperity, the other to the prosperity of a particular industry. Not a little harm has been done by the failure of governments to maintain this distinction between commercial and non-commercial loans, for it has encouraged legislators to neglect that careful investigation into the probable success of the enterprise to be established by the proceeds of the loan. It is not claimed that a government should always refrain from an investment that fails to promise commercial success, but that, if it choose to make such an investment, it should deceive neither itself nor the public by proceeding as though the obligations sold were commercial obligations. Good judgment of course cannot be guaranteed, but it would be of assistance in arriving at a conservative forecast of the future should there be an absolute separation in accounts and in rules of administration between

commercial and non-commercial loans Every enterprise should have its own account and its own administration; in no other way can responsibility for financial embarrassment be traced or the benefits from financial success be assigned.

A second reason for the separation of commercial from non-commercial loans springs from the accepted theory of governmental functions The services rendered by a government are either special or general in their character. Price is the means by which a government covers the cost of the former, while a tax is the means by which it covers the cost of the latter. It will of course be admitted that interest payments upon money borrowed for the establishment of a plant is one element in the cost of a commercial service, from which it follows that the debt must be assigned for support to the industry created This cannot be done except the investment be personalized and its accounts specialized In so far, therefore, as it is desired to maintain the distinction between special and general governmental services it is important to maintain the distinction between commercial and non-commercial obligations In the case of temporary or emergency loans there is no need of remembering the purposes for which the money was borrowed, for there is no administrative or legislative decision that can in any way be affected by such knowledge; but when a government enters upon the policy of investment loans, especially commercial investment loans, it comes within the influence of considerations that cannot be appreciated except the accounts of the government conform to business principles

This view of the case receives collateral support when one observes that the employment of public credit for a commercial purpose differs from the commercial employment of private credit in that the former creates a debt while the latter creates a property It is the nature of a debt to be extinguished by the prosperity of the enterprise for which it was created, it is the nature of commercial property, as, for example, the stock of a corporation, to be increased either in amount or in value by the prosperity of the enterprise which it represents It must, then, be held as sound policy when a government issues a commercial loan to clear the investment of its obligations as quickly as may be done by applying the

earnings of the business to the payment of the debt. This is true because an industry established through loans is not the property of the public until it exists as an unincumbered industry, and until that time the general property of citizens is liable for its support. Or, should one regard this as a dogmatical statement, the same thought may be presented by saying that the dangers incident to the employment of public credit for industrial investments are so great when taken in connection with the fact that the liability in case of failure extends beyond the industry in question, that a wise credit policy will insist that each industry clear up its own obligations before any of the ulterior advantages of the investment can be judiciously considered. We may, then, conclude that commercial credits form a class of obligations by themselves and should be recognised as such by the financier.

It is not possible to press further the analysis of investment loans without passing from the point of view of the financier to that of the administrator. It is, for example, a financial question which inquires whether public credit when employed to further industrial development shall be loaned to private corporations by guaranteeing the stocks and bonds, or whether the government should assume the direction of all enterprises of which it assumes the risk. But while this question is one to which the financier must make reply, the conclusion is one which involves so many political, social, and administrative interests that the analysis may properly be dropped from a cursory treatment of the general subject. This conclusion is typical of many other questions suggested by the subject in hand, and for this reason we may bring to a close at this point our consideration of investment financing.

CHAPTER III.

THE ADMINISTRATION OF A PUBLIC DEBT.

THE ISSUE OF A PUBLIC DEBT.

- (1) To what Motive should the Financier Appeal?
- (2) What should be the Terms of a Public Debt?

THE CONVERSION OF A PUBLIC DEBT.

THE PAYMENT OF A PUBLIC DEBT.

- (1) Why should a Public Debt be Paid?
- (2) How should a Public Debt be Paid?

It is the purpose of the present chapter to consider briefly those problems that present themselves to the financier in the administration of a public debt. These problems, which are more or less technical in character, pertain to the issue of a debt, the conversion of a debt, and the payment of a debt, and will be treated in the order of presentation.

81. The Issue of a Public Debt.—It may be assumed that in issuing its obligations a government desires to realize the largest amount of advantage for the least outlay of promise. In judging of advantage and outlay, however, a provident financier will hold in mind the fact that the State as a personality continues in perpetuity, and he will not on this account sacrifice the interests of the future to the exigencies of the present. A long series of questions present themselves to the financier who contemplates the issue of a loan which, so far as touched upon in this chapter, pertain, first, to the motives to which the financier should appeal, and second, to the adjustment of the terms of the debt contract

(1) *To what Motive should the Financier Appeal?*—There are three motives to which the financier may appeal to induce men to place their loanable capital at the disposal of the State. These motives are generosity, fear, and personal interest, and

the loans based upon them are called respectively patriotic loans, forced loans, and commercial loans.

It is sufficient to say respecting patriotic loans that they can form no permanent part of a credit policy, for patriotism as a motive to conduct, while strong during the period of its activity, is uncertain and unreliable. It does not lend itself to calculations and must be employed, if at all, when popular enthusiasm for a public cause is at its height. There are many instances in which an appeal to sentiment has secured for a government offers far in excess of the amount required, as was the case with the French loan for the payment of the war indemnity to Germany; or in which such an appeal has succeeded in obtaining funds after the commercial motive had apparently exhausted itself, as was the case with the United States loan secured when Mr. Fessenden was Secretary of the Treasury; but the success of such appeals will not deceive the financier. It is the occasion surrounding them rather than the character of the motive upon which they rely that explains their success. Moreover, patriotic loans are dangerous to public credit, for should they fail the fact would be accepted by the commercial investor as evidence that the government no longer enjoys the confidence of the public. We can, then, conclude that patriotic loans, while they may at times render most efficient service, must always be subordinated to the claims of commercial loans. It is their true function to create, to revive, or to support commercial confidence.

Forced loans present themselves in the history of finance in many forms, but we shall confine our attention to that form familiar to modern financiering, that is to say, the issue of legal-tender treasury notes. That the issue of such notes is an act of borrowing becomes evident whether one considers the process or the result. So far as the process is concerned the government desiring goods or services buys what it needs and offers in return a promise of future payment. Could these promises be discounted like ordinary commercial paper so as to enable the merchant or manufacturer who receives them to obtain cash when necessary to meet his own obligations the transaction would present no unusual features. But the promises under consideration are not commercially negotiable. They neither bear interest nor do they name a date at which

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they mature, and it is not likely that a merchant or manufacturer, knowing that he is to be paid in such a form of credit, would care to secure the government as a customer. In order, therefore, to relieve those who first receive these promises in return for goods or services the government, availing itself of its constitutional right to determine all questions relating to currency, attaches to these notes the legal power of paying private debts. This means that these notes are forcibly injected into the circulating medium of the country. They are received, not because men have confidence in them as a form of credit, but because the government threatens to withdraw its protection in matters of contract from all who refuse to assist in floating its notes. The transaction under consideration is a loan because by means of it the government secures goods or services in return for a promise to pay; it is a forced loan because no person who buys or sells within the jurisdiction of the government can evade the necessity of handling the notes.

The chief argument urged in support of legal-tender notes besides the argument of necessity, which the Science of Finance regards as a confession of ignorance or of weakness, is that by this means the government secures a fund of capital without the payment of interest. This advantage, however, is apparent rather than real, for it must be remembered that notes do not need the legal-tender quality to insure their acceptance except their issue is designed to make a redundant currency. Legal-tender notes, therefore, will inevitably inflate the circulating medium. It is of their nature to cause a rise in the level of prices. Since, now, the only purpose of the issue is to purchase goods or services, it is more than likely that what the government saves in interest it loses in the price it pays for goods. That this analysis of the argument is sound may be proven by a study of any attempt which any government has ever made to obtain money by a forced circulation of treasury notes, at least the author knows no illustration to the contrary.

The chief argument against legal-tender notes is that their issue involves the suspension of specie payments. This simple statement ought to be ample for one who appreciates the evils that follow upon a disordered currency. It may be possible that an extreme exigency may warrant so drastic a fiscal

measure, but the truth seems rather that no government with an approved cause can ever find itself in an exigency so extreme, except as the result of an erroneous fiscal policy or of a long series of blunders in the administration of a policy approved by science and experience. To begin a period of deficit financing by an act which must inevitably destroy the commercial machinery by which alone a sound financial policy can be successfully carried through must certainly be condemned.

Our general conclusion, then, is that patriotic loans are of restricted use, and that forced loans should be reserved for use, if used at all, as a last resort, from which it follows that commercial loans, resting on the ordinary business motives which underlie the processes of purchase and sale, should be employed in the carrying through of a credit policy.

(2) *What should be the Terms of a Public Debt?*—Recognising the private interest of the lender to be the chief, if not the exclusive, motive to which appeal should be made in the placement of a public debt, and acknowledging the price paid to be the most apparent test of its success, we proceed next to inquire respecting the terms of a debt contract, and in what manner this contract may be adjusted so as to meet the wishes of the lender without injuring the interests of the borrower. It of course goes without saying that the obligations offered for sale should admit of a certain degree of variety, for it is not conceivable that all lenders will be equally attracted by the same form of contract, but at the same time the financier must not show such solicitude for the whims of lenders as to introduce confusion into his accounts or to lose control of the situation.

The terms of a debt contract are three in number: first, the time for which it runs; second, the principal or amount to be paid; and third, the rate of interest or annuity. Theoretically any two of these may be determined by the government and the bid of the lender be expressed in the third. Within limits these terms are mutually convertible. Thus if the time for which a bond runs is long, say forty or fifty years, the rate of interest or annuity will be low; if, on the other hand, the time be short, say from two to five years, the rate will be relatively high. Either of these terms also may be converted into the principal of the debt, although in this

case a distinction must be made between the amount named in the bond and the price paid for the bond. It is not possible to consider in detail the relative significance of these terms, and we shall content ourselves with three definite statements respecting the form of a public debt.

(a) It is preferable for a government to promise a definite rate of interest upon a stated amount for a specific time than to promise a definite annual payment. The former in common language is called a bond, the latter an annuity. The reason for preferring a bond to an annuity is that a bond secures to the government the liberty of reducing the rate of interest if, through the subsequent rise of public credit or on account of an increase in the amount of loanable capital, the market rate for loans should fall below the nominal rate at which the loan is issued. For example, suppose twenty thousand dollars to be borrowed in the form of a bond at five per cent interest, the yearly payment would be one thousand dollars. Suppose the rate for loanable capital to fall to three per cent, and that the government pay off the old debt with money borrowed at the lower rate, it is clear that the government saves four hundred dollars a year by the transaction, a saving that could not have been made had the government contracted to pay six hundred dollars a year in perpetuity*.

(b) The element of time in a public bond should be fixed by the government in preference to the rate or the amount. The reason for this is that under no other conditions can a government control its obligations. This would not be worth saying in addition to what has been already said if it did not lead to a consideration of the time element in credit financing, in respect to which several important considerations suggest themselves. In the first place, the period during which the government guarantees its creditor against any modification of the terms of the contract, which is the period between the issue and the maturity of the bond, must be sufficiently extended to secure advantageous bids from those who loan the money. It is not possible to make a definite statement upon this point further than to say that the more highly

* The student will observe that this statement pertains to the issue of a debt in the form of a perpetual annuity and not to the payment of a debt by means of a terminable annuity. Perpetuity in credit financing means a promise that bears no date for maturity or payment.

developed the system of commercial credits within the community the greater will be the importance placed by lenders on the time for which an investment is guaranteed. Five years in a country like England, France, or the United States is little better than the mention of no date at all; twenty years, which a quarter of a century ago was ample, would now tend to depress the price of bonds, because it offers too short an investment; while a forty or fifty year guarantee is practically as good as perpetuity. The determination of the time for which a bond should run calls for a keen appreciation of commercial conditions and an exercise of good commercial sense.

What has thus far been said respecting time pertains to a great national debt contracted for general purposes, as, for example, a debt contracted for the prosecution of a war. Such a debt not only rests on taxes, but is of such magnitude as to demand special taxation for its support. The purpose for which it is issued also presents no considerations which bear upon the time for which it should be drawn. With temporary debts, on the other hand, or investment loans, whether commercial or non-commercial, the case is quite different. Temporary loans designed to balance the casual deficits and surpluses in the income of succeeding years will probably be drawn as interest-bearing treasury notes, and may or may not mention a date of maturity according to the whim of the market, but in any case three years is ample time for such notes to run. The time for which a non-commercial investment loan should run, let us say a loan for building a twenty-foot channel from the Great Lakes to the sea, should be calculated by the engineer and not by the financier, and the theory upon which his calculation should proceed is that the enterprise ought to become a clear property to the public before a new loan is needed for its reconstruction. Investments of this sort constitute a separate branch of credit financing. The time for which a commercial investment loan should run also must be determined by considerations that pertain to the enterprise established through its proceeds. Such a loan, while guaranteed by taxes, rests upon earnings, and, holding in mind the fact that it is the purpose of the government to establish the undertaking as an unincumbered public property, the time for which the obligation should be

guaranteed against repayment may be largely determined by ordinary business considerations.

An analysis of the time element in public bonds emphasizes what has been already suggested: that credit financing is of several sorts, and that the administration of a debt depends primarily upon the purpose for which credit is employed. The rule is as follows: temporary debts should be drawn with a view to their quick payment, exigency debts with a view to their subsequent conversion, and investment obligations with a view to their gradual expungement.

(c) The rate of interest named in a bond should be sufficiently high to secure its placement at or near par. The reason for this is bound up in the argument which favours the payment of a public debt. It is doubtless true that, other things being equal, a bond bearing a low rate of interest will, for the same annuity, permit the government to realize a higher amount of cash at the time of issue than a bond which bears a higher rate of interest. The lender will bid relatively higher for such a bond. Assuming for purposes of illustration that a hundred-dollar bond at five per cent will sell at par, a hundred-dollar bond at three per cent ought, mathematically calculated, to sell for \$66.66 $\frac{2}{3}$; but as a matter of fact it will sell for something more, so that in reality the government secures its money for something less than five per cent. But is this immediate gain worth the ultimate loss? Assuming the debt to be paid at maturity, the government will in the one case pay no more than it received; in the other case it will be forced to pay par for an obligation which it originally sold at a discount. The contention, then, is that a loan should be issued at par, and that a rate necessary to float obligations at par should be freely offered. The truth is that discount financing is in large measure responsible for the burden of perpetual debts now resting upon the world. "This is the principal cause," says M. Leroy-Beaulieu, "for the duration of public debts in Europe."*

82. The Conversion of a Public Debt.—By the conversion of a public debt is meant a modification of any of the

* For a fuller discussion of this point, as for consideration of other questions of form, the student is referred to my treatise on "Public Debts."

terms agreed upon at its issue. It may be assumed that the government is at liberty under the terms of the contract to effect changes, and that the changes will be to its advantage. Commonly the conversion of a debt contemplates the substitution of a lower for a higher rate of interest, by which the burden of a debt as measured by the annual payments which it occasions are lightened, and such will be the only modification of the contract we shall here consider.

The process of conversion is simple and scarcely merits the reputation granted the financiers who effect it. It consists in the issue of a new debt in place of an old one, and, provided the financier has just regard to the conditions of the money market, the holders of the old debt will in all probability exchange them freely for corresponding amounts of the new issue. There is no need, as in the case of the creation of new obligations, for the financier to consider the question of ways and means wherewith to float a debt; indeed, it is likely that the operation will permit the reduction of taxes. Nor is there any need for the financier to trouble himself about sustaining public credit, for the fact that conversion is possible shows that public credit is high, and every step in the process tends to raise it yet higher. We may, then, say that the merit which attaches to conversion belongs to that successful administration of the national finances by which public credit was established and public bonds rendered attractive; and it might be well for those who advocate repudiation in the interest of the taxpayer to remember that in so far as their advocacy is effective it not only increases the price which the government must pay for money when it borrows, but it causes the burden of a debt to continue longer than might otherwise be the case. The reduction of interest through conversion is the reward which comes from the scrupulous application of commercial honesty to public affairs; the continuance of a higher rate of interest than the market rate after the maturity of bonds is the penalty justly imposed upon a people careless of their public credit.

The financial question involved in the conversion of a public debt makes its appearance when one considers the relation of conversion to ultimate payment. A large debt cannot be paid at once. Not only would it be impossible for the government to obtain adequate funds through taxation, but the let-

is not universally conceded, and we shall, therefore, before asking how a debt may be paid inquire why it should be paid.

(1) *Why should a Public Debt be Paid?*—The reasons for the payment of public obligations may be the most efficiently suggested by consulting the principal argument urged against it. The burden of a debt, it is claimed, and rightly claimed, does not depend alone upon the amount of indebtedness or of the annuity which that indebtedness entails; it is equally important to consider the resources of the indebted nation. The debt rests upon resources, and relief from the burden of a debt may be secured either by reducing the debt or by strengthening the resources. A weight constitutes a burden according to the ratio it sustains to the strength of that which bears it; what reason can be urged for exhausting the energy that might go to the development of the nation's strength in reducing the burden to be carried? Such is the argument against debt payment, and that it has done effective service is shown by the vast amount of perpetual obligations which now bear down upon the industries of all civilized states.

Respecting the claim that industrial development decreases the burden of a debt there can be no doubt. The pressure of England's debt, for example, in 1815 is computed as equivalent to nine per cent of her yearly income; it is at the present time between two and three per cent of that income, but its reduction has not been effected so much by the expungement of obligations as by the growth of national wealth. The actual result, so far as debt burden is concerned, is the same as though two-thirds of the principal had been paid, the amount of her wealth remaining stationary. Other industrial nations show similar results, but the recognition of this necessary relation between the increase of resources and the decrease in the weight of public obligations is not final against the policy of debt payment; for if it can be shown that the payment of the principal of a debt has no tendency to retard the industrial development of a nation the argument fails to be conclusive. As opposed to the idea from which this reasoning must proceed I venture to place the following proposition, which if maintained will furnish an incontrovertible argument in favour of the policy of debt payment.*

* This argument in favor of debt payment is taken from my treatise on Public Debts, pp. 243-5.

The payment of the principal of a debt tends neither to impoverish a nation nor to retard its material development, but, on the other hand, the maintenance of the principal and the constant payment of accruing interest tend to cripple the productive capacity of any people.

The two parts of this proposition should receive separate attention, and we are led first to inquire if the industries of a country are injuriously affected by the process of payment. It is admitted by all that somewhere in the course of deficit financiering—either at the time the debt was established, or during the period that it was carried, or at the date of its payment—a loss is sustained chargeable to the adoption of the loan policy. Should one reason from the analogy of private debts he will conclude that this burden is borne at the time when the debt is paid, for when an individual debtor clears himself from obligations he loses control over a certain amount of free capital, and consequently lessens his importance as a member of industrial society. But such reasoning cannot be applied to the State. The State is not an individual, it has no life separate from the united lives of all citizens, and it recognises no interest but the collective interest of society. The State is the corporate representative of all citizens, creditors as well as debtors, and is not at all interested in the proprietary residence of capital, provided only it be judiciously employed. Since, then, the payment of its own obligations effects no more than a transfer of control over capital from one set of men to another, it cannot be said that the industrial development of the country is thereby obstructed.

The position here assumed may be easily understood if one hold firmly in mind the nature of capital. Capital is the subsistence fund, and he who controls it has it in his power to direct labour. It is capital which the State wants when it borrows money, and in borrowing capital it draws to its own use that which, had it not been thus appropriated, might have been applied to some productive industry under private management. The obligations which the State creates against itself are written in the language of money, because this is the most convenient language known for the expression of indebtedness; but the State has no use for money except to effect the transfer to itself of control over existing capital.

Suppose a State to borrow a billion dollars; it cannot be

said that industrial society is thereby necessarily rendered any the poorer. Capital is not destroyed by the borrowing. Before the loan was filled the nation was the possessor of a certain amount of capital, distributed in a thousand funds under the direction of a thousand wills; after the loan the nation as a whole holds the same amount of capital as before, the only difference being that control over it has passed to the State. Whether or not this operation is industrially detrimental depends upon the use to which the State puts the proceeds of its loan. If this be consumed in the prosecution of a war the nation is impoverished to the extent of the unproductive consumption, since capital, in the form of bacon, flour, clothes, implements, mules, and the like, has been destroyed. We may, then, conclude that the injury sustained on account of a loan for war purposes is sustained at the time the loan was contracted, and is due to the fact that the State has caused a certain amount of capital to disappear without hope of recovery.

Let us now turn to the process of payment. The obligations which the State has created against itself call for the payment of a certain amount of money. The money which it obtains by means of taxation is held for a moment, then transferred to the public creditors, and in this manner the State is freed from its indebtedness. It would, of course, be incorrect to say that this transfer of money from one set of citizens to another does not in the least disturb capital, but it may be rightly claimed that it does not destroy capital. Before the payment one set of individuals controlled the subsistence fund of the country to the extent of the payment; after the extinction of the debt ownership rests with another set of individuals. The government is freed from the necessity of providing an annual sum in the form of interest, and, measured by the amount of capital in the country, the nation is in no wise impoverished. There is the same amount of food for the subsistence of labourers, and the same amount of raw stuffs upon which to set them at work. If the new masters of capital are as enterprising as the old the nation loses nothing by the payment of its debt. This is the explanation, and in the explanation lies the defence of the proposition that the payment of a public debt does not necessarily impoverish a nation. The injury to industrial society is worked

by the destruction of capital at the time the loan was created; the labour required to create again the capital thus destroyed constitutes the burden imposed upon the nation; the payment of the principal of the debt is at most but a readjustment of ownership in existing capital. It is a fallacy to argue that the expungement of public obligations destroys capital.

But how is a people impoverished by the maintenance of the principal of a debt? In so far as bondholders live from the proceeds of their bonds they form a class not immediately interested in current industries. At some time in the past they may have furnished the government with large sums of capital, thus averting the inconvenience of excessive taxation or of a sudden change in rates, and in return for this service they received from the government the promise of an annuity until an equivalent of the original capital should be returned. Such persons are guaranteed a living without labour.

There is but one way in which the government may escape the necessity of supporting in idleness this class, and that is by paying its members their respective claims. The bondholders would in this manner be deprived of their secured annuity, but they would in its stead hold a sum of free capital, and if they now wish to continue in the enjoyment of an income from their property they must apply their funds to some productive purpose. In this manner the country gains by bringing to bear upon industrial affairs the interested attention of those who formerly were secured a living from the proceeds of public taxes. For another reason also is the payment of a debt advantageous. No people can long retain that hopefulness so essential to the vigorous prosecution of industries if the past lays heavy claims upon the present. As a rule they only should partake of current product who are in some way connected with current production. Carelessness and jealousy are not characteristics of efficient labour, but they are sentiments naturally engendered by the payment of taxes for the support of a favoured class. It is the permanency of this payment, rather than its amount, which exerts a depressing influence upon labour, and its extinction is a first step toward the establishment of confidence and contentment. It is for such reasons as these that we conclude that the policy of debt payment vigorously prosecuted will assist rather than retard industrial development.

(2) *How should a Public Debt be Paid?*—Accepting the policy of debt payment, by what means should it be carried through? For many years this question was so befogged by the intricacies of sinking-fund accounts as to mislead both financiers and the public. We shall not endeavour to follow the bibliography on this subject, but content ourselves, as when we considered the conversion of public debts, with a few definite statements respecting debt payment.

(a) It is not necessary at the time of creating a debt to include in the contract the terms of the payment, but, on the contrary, the law which authorizes the treasurer to borrow money and the law which authorizes him to repay the money borrowed should be separate and distinct acts of the legislature. The reasons for this are that public credit, in which a government is most vitally interested at the time of creating a debt, is not strengthened, but rather it is weakened, by the fact that the government binds itself to repayment. He who invests in the obligations of a strong State prefers an obligation that runs in perpetuity, and any promise looking to its payment will, other things being equal, tend to depress the price he is willing to pay. From another point of view also is a clause contracting repayment out of place in a law which creates a debt, for if it be conformed to it may necessitate that money be borrowed at high rates to pay an outstanding obligation at low rates. This is conversion inverted, and is absurd as a financial procedure. The result under such conditions is that as a matter of fact a government will disregard that part of the contract which calls for payment until the necessity of creating new debts shall have passed away. If, then, credit is depressed by a formal promise of repayment, and if the promise will be disregarded except under conditions when it is wise to pay the debt, is it not reasonable that the law which creates the debt should drop all consideration of repayment?

A positive reason also may be urged for separate legislation in the two cases. It is not possible at the time a debt is created, except in the case of a temporary debt or industrial loan, to forecast with any certainty the date at which or the conditions under which it may be wise to undertake repayment. It is much better for a present legislature to put confidence in the legislatures of the future. They will in all

probability be as wise and as patriotic, and, inasmuch as they stand nearer the transaction contemplated, it may be assumed that they will adjust the conditions of payment more perfectly to the requirements of the time. The law creating a debt should confine itself to the definition of those terms upon which public credit depends, and not undertake to forecast a policy that may in the exigencies of financing lie a quarter of a century in the future.

(b) A law designed to extinguish a debt should provide for the application of a clear income to the payment of the principal, and should not be encumbered with sinking-fund calculations. The reasoning upon this point is in one respect the same as that upon the point just passed in review, for the chief argument against sinking-funds is that a government should not be placed under the necessity of borrowing money to meet its promise of debt expungement. The theory of a sinking-fund, if theory it may be said to have, is simple. Assuming that a government enjoys an income equal to the interest on an existing debt, and a slight surplus, let us say equal to one per cent of the debt, which may also be assigned to the debt service, it is evident the debt is in a condition of gradual extinction. One per cent of the principal is paid the first year, and the interest payment for the second year is correspondingly reduced. During the second year not only can the one-per-cent clear income be used to further reduce the principal, but the saving of interest upon the purchase of the first year may also be used for that purpose, so that at the end of the second year the principal of the debt would stand as something between ninety-seven and ninety-eight per cent of its original amount. In other words, the government buys a portion of its own debt, pays to itself the interest accruing upon that portion, and employs this amount for the purchase of more principal. Two things are evident: first, so long as the appropriation originally assigned to the service of the debt is kept up the process of debt payment continues, and second, the rate of payment conforms to the rule of compound interest.

If this idea of compound interest be firmly grasped the student can understand the form of argument urged by the advocates of a sinking-fund. It is wise, so said these mathematical experts, to borrow money at six per cent in order to

continue the purchase of five-per-cent bonds, because the former represents an operation in simple interest, while the latter represents an operation in compound interest. The error of this statement does not lie in its mathematics, but in the assumption that the purchase by a government of its own obligations is a productive investment. The argument overlooks the fact that whatever the government pays for the support of the debt, whether it goes through the sinking-fund or not, comes from taxes, and it is bad financiering to take six dollars out of taxes to pay the interest on one hundred dollars of new debt in order to pay off one hundred dollars of debt which demands an interest payment of five dollars only. The principal of the debt is not changed by the operation, while the burden of the debt is increased. So long as one holds in mind the total of the debt and the total of the amount assigned each year to the service of the debt he will not be misled by sinking-fund calculations. The theory assumes the sinking-fund to be productive, whereas it is not productive. It is not a productive process to pass money from one account to another when both accounts belong to the same person *

An apparent exception to this sweeping condemnation of sinking-funds may be made in favour of local financiering and industrial loans. A local government is but a small fragment of the nation. It is a corporation among corporations, and it may occur that taxes which it has imposed for the extinction of its obligations cannot be judiciously used on account of the high market price of its bonds. This being the case, it would probably be wise, rather than remit the taxes or divert them to some other use, to invest their proceeds in some form of commercial paper. This investment would undoubtedly be called a sinking-fund, but it would differ from the sinking-fund of the sort we have considered in that the investment constitutes a source of income to the local government independent of taxes. It is true the taxes must be maintained to pay the interest on its own outstanding obligations, so that so far as income and expenditure are concerned there may be neither gain nor loss; the gain from the transaction becomes apparent when, the bonds of the local government having matured, and their price on that account having been brought down to par, the property in the investment

* Cf. Dr E. A. Ross's monograph on *Sinking Funds*.

fund can be sold and the proceeds of the sale applied to the extinction of the local debt. The advantage of such a procedure is that a local government can continue the application of a free income to the reduction of its debt, and at the same time obviate the necessity of paying a premium on unmatured bonds.

The case of industrial loans is yet simpler. Each industrial loan represents a specific investment, and probably an investment subject to deterioration through use. We have already considered the time for which such loans should run, and it may be wise, as a precaution against their non-payment by the time the investment is worn out, to establish a sinking-fund in connection with the loan.

Our conclusion, then, is as follows: Nothing pays a debt except clear income, and the interest which accrues to a government through the purchase of its own bonds does not constitute such an income. In order to continue a policy of debt payment, and at the same time obviate the purchase of bonds at a premium, however, it may be wise for local governments to make a temporary investment of the money assigned to debt payment in interest-bearing paper other than its own bonds. For industrial loans, also, the fact that the specialization of investments is essential to sound administration warrants the use of sinking-funds.

(c) The third observation respecting the policy of debt payment is that it is better to provide for the expungement of a debt by operating upon the principal than by converting the principal into a series of terminable annuities. By an annuity is meant a specified annual payment; a terminable annuity is a payment that terminates at a specific date. It is not an unusual practice to convert a bond into an annuity to run for a series of years, and by this means to provide for the payment of a debt. Suppose, for example, that an hundred-dollar bond bear six per cent interest: the annuity will then be six dollars. Suppose the government offer to receive this bond which runs in perpetuity in exchange for a simple promise to pay eight dollars a year for twenty-three years: at the expiration of the period the debt will be extinguished. The application of two dollars a year to the payment of the principal, increased by the interest accruing on the principal paid, will have extinguished the debt.

The argument against terminable annuities is the same as the argument against the sinking-fund. Indeed, a terminable annuity is a sinking-fund that cannot be alienated from its purpose, because the payment is a part of the contract and so interwoven with the interest accrual that it cannot be separated. The interest and the payment are lumped together in the contract. It is thus evident that annuities realize in practice the error that sinking-funds imply in theory, namely, the inviolability of a payment upon a specific portion of a debt, even though the government may find itself in a situation where it must borrow new funds at a higher rate of interest. This by no means exhausts the discussion upon terminable annuities as a means of debt payment, but it at least indicates their financial character and suggests the point of view from which that discussion should proceed. It may be laid down as a principle that the policy of debt payment for a government exposed to fiscal exigencies should be at all times under absolute control; this is not contemplated by the theory of sinking-funds, it is not possible under the practice of terminable annuities.

(d) It may perhaps be added as a final observation that the policy of debt payment should be formulated at the time the debt is thrown into its definite shape, which means that both the funding of floating obligations and the process of conversion, which inevitably follow the creation of a debt under the stress of an exigency, should be so carried through as to bring the debt into shape for orderly and uniform payment. There is no other single act in connection with this branch of financing that calls for so high a grade of business judgment. This, however, has been suggested in connection with the analysis of the process of conversion.

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